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Administrator of National Banks

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Background

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of the Treasury. The OCC is headed by the Comptroller who is appointed by the President, with the advice and consent of the Senate, for a 5-year term.

The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital or other changes in corporate or banking structure;
- Take supervisory actions against banks that do not conform to laws and regulations or which otherwise engage in unsound banking practices, including removal of officers, negotiation of agreements to change existing banking practices, and issuance of cease and desist orders; and
- Issue rules and regulations concerning banking practices and governing bank lending and investment practices and corporate structure.

The OCC divides the United States into six geographical districts, with each headed by a Deputy Comptroller.

The Office is funded through assessments on the assets of national banks.

The Comptroller

Eugene A. Ludwig took the oath of office on April 5, 1993, as the 27th Comptroller of the Currency.

By statute, the Comptroller serves a concurrent term as Director of the Federal Deposit Insurance Corporation and the Neighborhood Reinvestment Corporation. The Comptroller also serves as a member of the Federal Financial Institutions Examination Council.

Mr. Ludwig joined the OCC from the law firm of Covington and Burling in Washington, D.C., where he was a partner beginning in 1981. He specialized in intellectual property law, banking, and international trade. He has written numerous articles on banking and finance for scholarly journals and trade publications, and served as a guest lecturer at Yale and Harvard Law Schools and Georgetown University's International Law Institute.

Mr. Ludwig grew up in York, Pennsylvania, where he attended York Suburban High School. He earned a B.A. magna cum laude from Haverford College in Pennsylvania. He received a Keasbey scholarship to attend Oxford University, where he studied politics, philosophy, and economics and earned a B.A. and M.A. He holds an LL.B. from Yale University, where he served as editor of the Yale Law Journal and chairman of Yale Legislative Services.

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year in March, June, September and December. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and testimony, material released in the interpretive letters series, statistical data and other information of interest to the administration of national banks. Suggestions, comments or questions on content may be sent to Claire Emory, Senior Writer/Editor, Communications Division, Comptroller of the Currency, Washington, D.C. 20219. Subscriptions are available for $60 a year by writing to Publications—QJ, Comptroller of the Currency, Washington, D.C. 20219.

Quarterly Journal

Office of the Comptroller of the Currency

Eugene A. Ludwig

Comptroller of the Currency

The Administrator of National Banks

Contents

Operations of National Banks

National banks reported their second highest ever quarterly earnings in the second quarter of 1994. Preliminary operating results of 3,191 national banks show that higher net interest income offset a small decline in noninterest income and a slight rise in loan loss provisions. The strength in earnings remains widespread. For the second consecutive quarter, one-third of all national banks recorded an annualized quarterly return on equity (ROE) of more than 15 percent. Only 4 percent of all national banks lost money in the quarter.

The resurgence in loan growth at national banks that began in the second quarter of last year continued to gather momentum in the second quarter of 1994. Total loans grew at a faster pace in the quarter than they had over the previous four quarters, and securities holdings of banks decreased for the first time since the fourth quarter of 1990. The growth in loans is particularly noteworthy because it occurred despite the conversion of Continental Bank from a national charter to a state charter. The departure of the $21.3 billion bank decreases the size of the national banking system by almost 1 percent.

Strong Profits Again

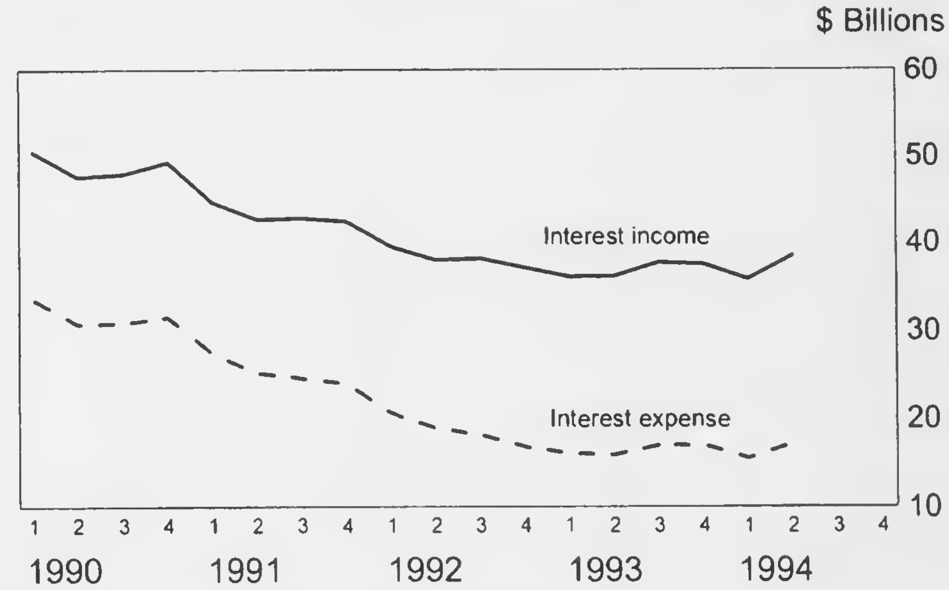
The second quarter marked the sixth consecutive quarter that national banks earned over $6 billion and recorded an annualized quarterly ROE greater than 15 percent. National banks earned $6.7 billion in the quarter, an increase of $202 million from the first quarter and $196 million less than the record set in the third quarter of 1993. The aggregate annualized quarterly ROE for national banks in the second quarter was 16.3 percent, up from 15.8 percent in the first quarter. For the first half of 1994 as a whole, national banks earned $13.2 billion, compared to $12.5 billion in the first half of 1993.

Net income

Source: call reports

The improvement in earnings in the second quarter over the first quarter was due primarily to an increase in net interest income. Net interest income rose by $1.0 billion to $21.4 billion, as interest income rose faster than interest expense. The net interest margin — the ratio of net interest income to average assets increased by 14 basis points from the previous quarter to 3.97 percent.

Interest income and interest expense



Source: call reports

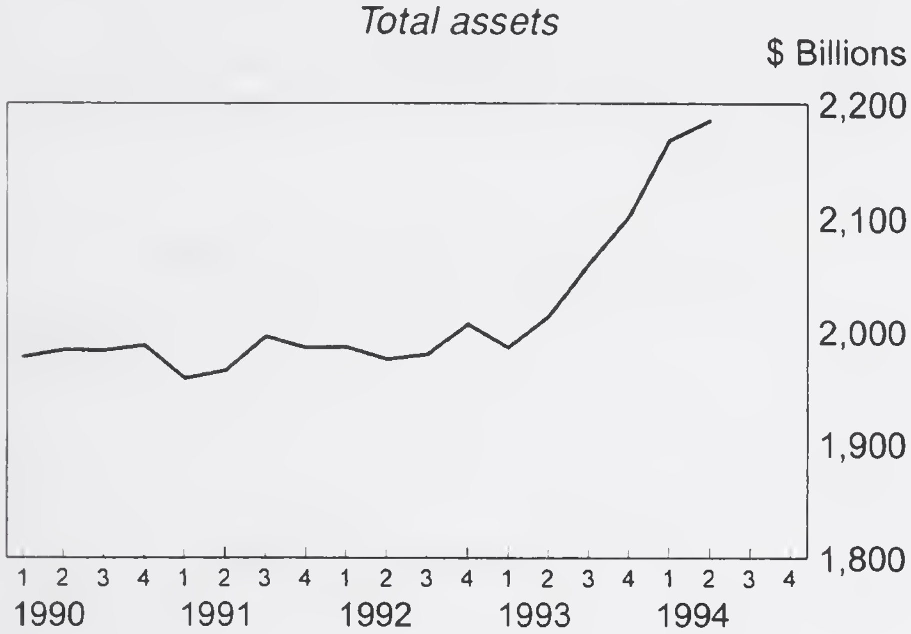
The increase in net interest income offset the second consecutive quarterly decrease in noninterest income. In the second quarter, noninterest income declined by $271 million to $11.1 billion. In the first quarter, noninterest income declined by $706 million from the previous quarter. Noninterest income from trading activities, which declined by $432 million in the first quarter, increased by $92 million in the second quarter to $708 million.

Loan loss provisions rose by $36 million from the previous quarter to $1.5 billion in the second quarter, the first quarterly increase since the third quarter of 1992. However, provisions in the second quarter of 1994 were $730 million less than provisions in the second quarter of 1993. The slightly higher provisions were not accompanied by a deterioration of other credit quality indicators. For example, the total amount of noncurrent loans fell by $3.3 billion in the quarter to $21.3 billion, and the percentage of total loans that are noncurrent fell to 1.6 percent from 1.9 percent.

Loans Up, Securities Down

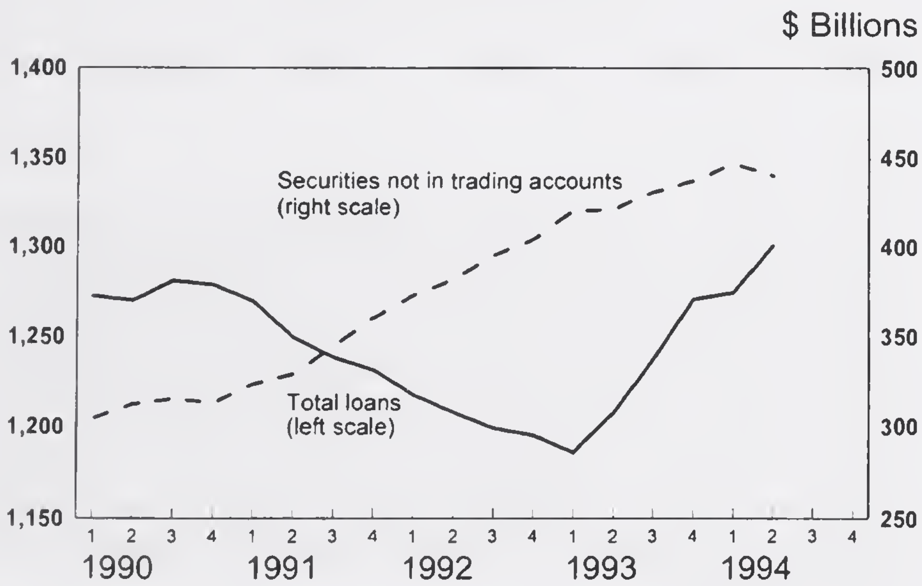
Loans outstanding at national banks increased at an 8.2 percent annual rate in the second quarter, up from an average annualized growth rate of 7.3 percent over the previous four quarters. However, aggregate national bank statistics for the second quarter compared to the first quarter understate the strength of loan growth because of the conversion of Continental Bank to a state charter during the second quarter of this year. Adjusted for the conversion, loans at national banks would have increased at an 11.9 percent annual rate in the quarter.

Total assets



Source: call reports

Loans and securities



Source: call reports

For the fifth consecutive quarter, all three major categories of loans, real estate, consumer, and commercial and industrial loans, grew. Real estate and consumer loans both increased strongly in the second quarter. Real estate loans rose $11.5 billion in the second quarter, compared to a $2.6 billion decrease in the first quarter. Consumer loans increased $10.8 billion in the second quarter, compared to a $1.9 billion increase in the previous quarter. Commercial and industrial loans increased by only $2.0 billion; this loan category was most affected by the conversion of Continental Bank, because $8.2 billion of that bank's $12 billion in loans are commercial and industrial loans.

Securities holdings of national banks declined in the second quarter for the first time since the fourth quarter of 1990. Total securities (not in trading accounts) held by national banks decreased by $6.8 billion to $440.0 billion. Not all types of securities decreased, however. Holdings of treasury securities decreased by $5.5 billion to $140.6 billion, while holdings of mortgage-backed securities increased by $778 million to $188.0 billion. The continued rise in market interest rates in the second quarter further eroded the value of national banks' securities holdings. As of the end of the second quarter, the market value of national banks' securities holdings was $8.1 billion, or 1.8 percent, below their book value. At the end of the first quarter, the market value of national bank securities was $1.7 billion, or 0.4 percent, below book value.

Capital Increases Slightly

Equity capital increased by $1.3 billion to $168.2 billion in the second quarter. Net unrealized gains (losses) on available for sale securities decreased equity capital by $2.5 billion in the second quarter, compared to a decrease of $671 million in the first quarter.

Capital ratios changed little in the second quarter. The equity capital ratio remained at 7.70 percent, the leverage ratio rose 5 basis points to 7.40 percent, and the risk-based capital ratio fell 8 basis points to 12.54 percent.

Aggregate performance data for national banks
(Data through second quarter of each year)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*
Industry Structure						
Number of banks	4,280	4,061	3,911	3,699	3,449	3,191
Number of banks with losses	571	545	553	286	200	116
Number of failed/assisted banks	51	68	26	14	15	3
Income Statement ($ Billions)						
Year-to-Date:						
Net income	8.38	5.87	5.05	8.56	12.45	13.18
Net interest income	33.54	33.48	34.87	37.50	40.03	41.33
Noninterest income	15.44	17.03	18.05	19.79	22.09	22.21
Noninterest expense	32.26	34.08	36.37	38.21	41.59	41.00
Loan loss provision	5.30	8.32	10.00	8.03	4.99	2.89
Gains on securities sales, net	0.13	0.11	0.48	1.09	0.85	0.46
Extraordinary income, net	0.26	0.08	0.63	0.18	1.58	–0.03
Net loan loss	5.93	9.84	9.90	7.38	5.16	3.04
Second Quarter:						
Net income	4.05	2.56	2.08	4.43	6.21	6.73
Net interest income	16.83	16.89	17.62	19.15	20.29	21.36
Noninterest income	8.06	8.51	9.16	10.23	11.42	11.07
Noninterest expense	16.52	17.36	18.51	19.66	20.63	20.94
Loan loss provision	2.86	4.32	5.41	3.73	2.21	1.48
Gains on securities sales, net	0.11	0.04	0.21	0.38	0.34	0.13
Extraordinary income, net	0.11	–0.03	0.29	0.08	0.07	0.00
Net loan loss	3.36	5.58	5.75	3.56	2.69	1.63
Performance Ratios (%)						
Year-to-Date:						
Return on equity	15.07	10.12	8.28	13.14	16.72	16.11
Return on assets	0.90	0.60	0.51	0.88	1.26	1.25
Net interest margin	3.59	3.42	3.54	3.86	4.04	3.92
Loss provision to loans	0.88	1.33	1.59	1.34	0.84	0.46
Net loan loss to loans	0.99	1.57	1.57	1.24	0.87	0.48
Noncurrent loans to loans	3.20	3.44	4.38	3.90	2.86	1.64
Loss reserves to loans	2.34	2.40	2.65	2.82	2.69	2.41
Loss reserves to noncurrent loans	73.14	69.69	60.48	72.22	94.05	146.87
Loans to assets	64.43	64.02	63.61	61.16	59.96	59.51
Loans to deposits	85.26	83.48	81.41	78.31	78.97	83.13
Equity to assets	6.01	6.03	6.31	6.93	7.74	7.70
Estimated leverage ratio	N/A	5.79	5.98	6.56	7.24	7.40
Estimated risk-based capital ratio	N/A	8.65	9.62	10.83	12.25	12.54

Note: 1994 data are preliminary.
Regulatory and Statistical Analysis (09/15/94)

Aggregate condition data for national banks
(Data through second quarter of each year)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*
Balance Sheet ($ Billions)						
Assets	1,896.50	1,983.35	1,964.50	1,975.03	2,013.87	2,185.25
Loans	1,221.86	1,269.81	1,249.52	1,207.84	1,207.47	1,300.39
Real estate (RE)	437.69	490.17	506.55	500.82	503.28	535.95
Commercial & industrial (C&I)	383.53	388.84	367.03	338.34	335.96	354.99
Consumer (cnsmr)	238.65	235.29	232.19	226.84	230.62	263.32
Noncurrent loans	39.07	43.70	54.73	47.16	34.57	21.31
Noncurrent RE loans	13.18	19.41	28.65	26.12	20.27	13.06
Noncurrent C&I loans	13.89	15.00	18.41	14.21	9.06	4.44
Noncurrent cnsmr loans	2.74	0.22	3.27	3.26	3.06	2.73
Other real estate owned	7.57	10.71	17.48	18.45	14.88	8.40
Securities not in trading account*	284.52	312.05	329.05	381.54	420.88	440.02
Total liabilities	1,782.47	1,863.64	1,840.53	1,838.06	1,857.90	2,017.03
Total deposits	1,433.11	1,521.15	1,534.84	1,542.46	1,528.95	1,564.28
Domestic deposits	1,238.10	1,316.93	1,345.61	1,349.08	1,328.93	1,324.06
Loan loss reserve	28.58	30.45	33.10	34.06	32.51	31.30
Equity capital	113.95	119.64	123.97	136.96	155.96	168.23
Total capital	N/A	144.43	152.16	164.03	186.73	200.79
Balance Sheet Changes ($ Billions)						
Year-to-Date Changes:						
Assets	46.87	3.79	−22.98	−10.23	7.08	83.22
Loans	34.37	−4.31	−29.07	−23.43	12.40	29.72
Noncurrent loans	2.98	2.68	2.89	−3.24	−5.54	−5.01
Other real estate owned	0.83	1.49	3.02	0.78	−2.28	−2.09
Securities not in trading account*	9.19	17.57	16.11	21.33	17.04	2.91
Total liabilities	41.29	−1.93	−26.72	−19.97	−3.81	79.98
Total deposits	15.21	15.53	−23.72	−30.79	−22.74	−12.80
Loan loss reserve	−1.32	−1.99	−1.13	0.21	−0.55	−0.25
Equity capital	5.58	5.72	3.74	9.74	10.90	3.24
Total capital	N/A	N/A	2.73	8.78	13.38	6.25
Second Quarter Changes:						
Assets	38.81	6.23	7.24	−10.94	28.07	17.16
Loans	26.69	−2.41	−19.99	−9.80	21.89	26.00
Noncurrent loans	1.72	1.36	−0.37	−2.44	−3.25	−3.27
Other real estate owned	0.40	1.56	1.03	0.02	−1.56	−1.33
Securities not in trading account*	4.42	8.09	5.79	8.76	0.95	−6.76
Total liabilities	36.45	5.25	5.84	−16.90	23.96	15.83
Total deposits	12.39	20.90	5.52	−21.13	7.75	−4.21
Loan loss reserve	−0.52	−1.60	−0.45	−0.49	−0.53	−0.36
Equity capital	2.36	0.98	1.41	5.96	4.11	1.33
Total capital	N/A	1.33	0.21	4.98	6.33	1.62

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.
Note: 1994 data are preliminary. Regulatory and Statistical Analysis (09/15/94)

Aggregate performance data for national banks by size
(Data through second quarter of each year)

	Under $100M		*$100M-$1B*		*$1B-$10B*		*Over $10B*		*Total*	
	1993	*1994*	*1993*	*1994*	*1993*	*1994*	*1993*	*1994*	*1993*	*1994*
Industry Structure										
Number of banks	2,131	1,903	1,116	1,079	164	174	38	35	3,449	3,191
Number of banks with losses	145	88	44	23	9	5	2	0	200	116
Number of failed/assisted banks	11	2	4	1	0	0	0	0	15	3
Income Statement ($ Billions)										
Year-to-Date:										
Net income	0.61	0.54	1.91	1.85	3.87	4.63	6.05	6.15	12.45	13.18
Net interest income	2.15	1.94	6.45	6.17	12.04	13.27	19.39	19.96	40.03	41.33
Noninterest income	0.65	0.71	2.02	2.08	7.24	7.92	12.18	11.50	22.09	22.21
Noninterest expense	1.93	1.83	5.41	5.23	12.36	13.22	21.89	20.72	41.59	41.00
Loan loss provision	0.09	0.00	0.51	0.30	1.62	1.10	2.77	1.49	4.99	2.89
Gains on securities sales, net	0.04	0.00	0.08	0.02	0.22	0.10	0.51	0.34	0.85	0.46
Extraordinary income, net	0.04	0.00	0.12	0.00	0.12	–0.01	1.29	–0.03	1.58	–0.03
Net loan loss	0.08	0.04	0.42	0.27	1.54	1.24	3.13	1.49	5.16	3.04
Second Quarter:										
Net income	0.31	0.28	0.96	0.95	2.12	2.32	2.82	3.19	6.21	6.73
Net interest income	1.04	0.99	3.26	3.17	6.27	6.76	9.71	10.44	20.29	21.36
Noninterest income	0.31	0.36	1.04	1.06	3.81	4.07	6.26	5.58	11.42	11.07
Noninterest expense	0.93	0.93	2.73	2.66	6.42	6.76	10.55	10.59	20.63	20.94
Loan loss provision	0.01	–0.02	0.25	0.15	0.72	0.61	1.23	0.74	2.21	1.49
Gains on securities sales, net	0.01	–0.01	0.03	–0.01	0.13	0.00	0.17	0.14	0.34	0.13
Extraordinary income, net	0.01	0.00	0.05	0.00	0.01	0.00	0.01	0.00	0.07	0.00
Net loan loss	0.01	0.03	0.21	0.16	0.81	0.68	1.66	0.77	2.69	1.63
Performance Ratios (%)										
Year-to-Date:										
Return on equity	12.70	12.27	15.72	14.94	18.37	18.88	16.62	15.20	16.72	16.11
Return on assets	1.22	1.19	1.31	1.32	1.43	1.51	1.15	1.09	1.26	1.26
Net interest margin	4.28	4.25	4.44	4.38	4.44	4.34	3.70	3.54	4.04	3.92
Loss provision to loans	0.35	0.01	0.61	0.36	1.00	0.58	0.86	0.44	0.84	0.46
Net loan loss to loans	0.32	0.18	0.50	0.33	0.95	0.66	0.97	0.44	0.87	0.48
Noncurrent loans to loans	1.72	1.27	1.62	1.15	2.29	1.41	3.56	1.91	2.86	1.64
Loss reserves to loans	1.84	1.66	1.96	1.76	2.96	2.45	2.81	2.59	2.69	2.41
Loss reserves to noncurrent loans	106.77	131.13	121.32	152.87	129.14	173.39	78.95	135.83	94.05	146.87
Loans to assets	50.33	52.31	57.80	59.19	60.21	61.89	61.32	58.88	59.96	59.51
Loans to deposits	57.24	59.96	68.33	71.44	79.37	85.45	84.62	87.61	78.97	83.13
Equity to assets	9.65	9.77	8.58	8.86	8.04	8.09	7.19	7.05	7.74	7.70
Estimated leverage ratio	9.50	9.82	8.36	8.82	7.65	7.75	6.52	6.68	7.24	7.40
Estimated risk-based capital ratio	18.32	18.53	14.69	15.22	12.86	12.88	11.11	11.54	12.25	12.54

Note: 1994 data are preliminary. 0.00 indicates an amount of less than $5 million.
Regulatory and Statistical Analysis (09/15/94)

Aggregate condition data for national banks by size
(Data through second quarter of each year)

	Under $100M		*$100M-$1B*		*$1B-$10B*		*Over $10B*		*Total*	
	1993	*1994*	*1993*	*1994*	*1993*	*1994*	*1993*	*1994*	*1993*	*1994*
Balance Sheet ($ Billions)										
Assets	99.97	91.67	292.28	284.77	551.70	623.96	1,069.91	1,184.85	2,013.87	2,185.25
Loans	50.32	47.95	168.93	168.57	332.20	386.19	656.02	697.68	1,207.47	1,300.39
Real estate (RE)	27.79	26.40	92.16	91.48	134.93	159.18	248.40	258.89	503.28	535.95
Commercial & industrial (C&I)	8.62	8.10	30.41	28.59	78.54	86.53	218.40	231.78	335.96	354.99
Consumer (cnsmr)	8.57	8.02	37.95	39.59	90.57	112.74	93.43	102.97	230.62	263.32
Noncurrent loans	0.87	0.61	2.73	1.94	7.61	5.46	23.36	13.30	34.57	21.31
Noncurrent RE loans	0.45	0.32	1.56	1.10	4.48	3.23	13.79	8.41	20.27	13.06
Noncurrent C&I loans	0.35	0.23	0.87	0.57	1.72	1.07	6.13	2.57	9.06	4.44
Noncurrent cnsmr loans	0.06	0.05	0.26	0.24	1.07	0.94	1.66	1.49	3.06	2.73
Other real estate owned	0.46	0.27	1.29	0.70	3.05	1.34	10.08	6.10	14.88	8.40
Securities not in trading account*	36.02	32.77	86.91	86.68	134.33	149.89	163.61	170.68	420.88	440.02
Total liabilities	90.33	82.72	267.20	259.53	507.36	573.49	993.02	1,101.29	1,857.90	2,017.03
Total deposits	87.91	79.97	247.22	235.97	418.54	451.96	775.29	796.37	1,528.95	1,564.28
Domestic deposits	87.89	79.97	246.99	235.54	411.95	440.53	582.10	568.03	1,328.93	1,324.06
Loan loss reserve	0.92	0.80	3.32	2.96	9.83	9.47	18.44	18.07	32.51	31.30
Equity capital	9.64	8.96	25.08	25.24	44.35	50.47	76.89	83.56	155.96	168.23
Total capital	10.23	9.63	26.93	27.30	50.04	56.57	99.54	107.28	186.73	200.79
Balance Sheet Changes ($ Billions)										
Year-to-Date Changes:										
Assets	-2.01	-3.86	-15.80	-6.32	-21.88	15.25	46.77	78.15	7.08	83.22
Loans	0.02	-0.36	-6.38	1.20	-3.17	14.52	21.93	14.37	12.40	29.72
Noncurrent loans	-0.04	-0.09	-0.47	-0.32	-1.08	-1.18	-3.95	-3.42	-5.54	-5.01
Other real estate owned	-0.10	—0.05	-0.36	-0.19	-0.66	-0.63	-1.17	-1.22	-2.28	-2.09
Securities not in trading account*	0.30	-1.08	-0.84	-2.00	-0.88	3.53	18.46	2.46	17.04	2.91
Total liabilities	-2.20	-3.62	-16.21	-6.39	-23.69	13.35	38.28	76.64	-3.81	79.98
Total deposits	-2.54	-3.92	-17.35	-9.76	-23.26	-1.57	20.40	2.46	-22.74	-12.80
Loan loss reserve	-0.02	-0.04	-0.17	-0.19	-0.37	-0.23	0.01	0.20	-0.55	-0.26
Equity capital	0.19	-0.24	0.04	0.07	1.18	1,90	8.49	1.51	10.90	3.24
Total capital	0.22	-0.08	0.36	0.63	3.23	2.96	9.57	2.73	13.38	6.25
Second Quarter Changes:										
Assets	-1.94	-2.16	-7.14	-4.02	8.83	21.88	28.32	1.45	28.07	17.16
Loans	-0.28	0.37	-2.13	1.90	7.49	20.26	16.80	3.47	21.89	26.00
Noncurrent loans	-0.07	-0.07	-0.26	-0.18	-0.41	-0.95	-2.51	-2.07	-3.25	-3.27
Other real estate owned	-0.09	-0.02	-0.21	-0.08	-0.38	-0.33	-0.88	-0.89	-1.56	-1.33
Securities not in trading account*	-0.47	-1.03	-1.71	-2.70	-0.56	2.51	3.69	-5.54	0.95	-6.76
Total liabilities	-1.92	-2.00	-6.81	-3.67	7.35	19.72	25.34	1.77	23.96	15.83
Total deposits	-2.25	-2.27	-7.65	-5.87	4.18	7.90	13.47	-3.96	7.75	-4.21
Loan loss reserve	-0.04	-0.02	-0.15	-0.12	-0.06	-0.14	-0.29	-0.09	-0.53	-0.36
Equity capital	-0.02	-0.16	-0.33	-0.35	1.48	2.17	2.98	-0.33	4.11	1.33
Total capital	-0.04	-0.05	-0.31	0.19	2.09	2.42	4.59	-0.94	6.33	1.62

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.

Note: 1994 data are preliminary. Regulatory and Statistical Analysis (09/15/94)

Aggregate performance data for national banks by region
(Data through second quarter of 1994)

	Northeast	*Southeast*	*Central*	*Midwest*	*Southwest*	*West*	*Total*
Industry Structure							
Number of banks	355	442	678	567	765	384	3,191
Number of banks with losses	13	14	15	11	25	38	116
Number of failed/assisted banks	0	0	0	1	1	2	3
Income Statement ($ Billions)							
Year-to-Date:							
Net income	4.02	2.23	2.21	1.16	1.16	2.40	13.18
Net interest income	13.06	6.91	6.89	3.02	3.67	7.79	41.33
Noninterest income	8.29	2.91	2.69	2.20	1.75	4.38	22.21
Noninterest expense	14.23	6.31	5.97	3.19	3.72	7.58	41.00
Loan loss provision	1.45	0.25	0.35	0.26	0.01	0.58	2.89
Gains on securities sales, net	0.34	0.06	0.02	0.02	0.01	0.01	0.46
Extraordinary income, net	–0.03	0.00	–0.01	0.00	0.00	0.00	–0.03
Net loan loss	1.51	0.24	0.31	0.25	0.05	0.68	3.04
Second Quarter:							
Net income	2.02	1.15	1.16	0.60	0.55	1.24	6.73
Net interest income	6.89	3.57	3.54	1.53	1.86	3.97	21.36
Noninterest income	4.04	1.40	1.41	1.13	0.84	2.25	11.07
Noninterest expense	7.43	3.15	3.07	1.60	1.86	3.83	20.94
Loan loss provision	0.81	0.10	0.15	0.12	0.01	0.29	1.48
Gains on securities sales, net	0.17	0.01	0.00	–0.03	0.00	–0.01	0.13
Extraordinary income, net	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Net loan loss	0.85	0.11	0.17	0.12	0.03	0.35	1.63
Performance Ratios (%)							
Year-to-Date:							
Return on equity	15.56	16.35	16.24	20.18	14.34	16.08	16.11
Return on assets	1.14	1.21	1.27	1.64	1.15	1.39	1.25
Net interest margin	3.69	3.75	3.96	4.27	3.65	4.51	3.92
Loss provision to loans	0.70	0.22	0.33	0.59	0.03	0.50	0.46
Net loan loss to loans	0.73	0.22	0.30	0.58	0.09	0.59	0.48
Noncurrent loans to loans	2.35	1.05	1.05	1.08	1.01	1.93	1.64
Loss reserves to loans	2.78	1.87	1.94	2.02	1.76	3.11	2.41
Loss reserves to noncurrent loans	118.03	178.29	184.95	186.11	174.20	161.30	146.87
Loans to assets	57.13	60.96	60.20	61.50	50.99	66.41	59.51
Loans to deposits	84.91	85.08	83.59	87.04	63.48	87.77	83.13
Equity to assets	7.22	7.42	7.74	8.18	8.15	8.52	7.70
Estimated leverage ratio	7.03	7.31	7.69	8.04	7.65	7.61	7.40
Estimated risk-based capital ratio	12.33	11.90	12.67	13.29	13.79	12.63	12.54

Note: 1994 data are preliminary. 0.00 indicates an amount of less than $5 million.
Regulatory and Statistical Analysis (09/15/94)

Aggregate condition data for national banks by region
(Data through second quarter of 1994)

	Northeast	*Southeast*	*Central*	*Midwest*	*Southwest*	*West*	*Total*
Balance Sheet ($ Billions)							
Assets	754.01	373.77	360.93	141.66	201.40	353.48	2,185.25
Loans	430.74	227.84	217.27	87.12	102.69	234.74	1,300.39
Real estate (RE)	156.42	111.49	87.63	30.91	44.55	104.95	535.95
Commercial & industrial (C&I)	137.33	53.55	56.79	20.38	28.84	58.12	354.99
Consumer (cnsmr)	76.70	43.06	53.27	24.51	20.73	45.05	263.32
Noncurrent loans	10.14	2.39	2.28	0.94	1.04	4.52	21.31
Noncurrent RE loans	5.98	1.61	1.18	0.37	0.61	3.32	13.06
Noncurrent C&I loans	2.04	0.53	0.70	0.27	0.30	0.62	4.44
Noncurrent cnsmr loans	1.49	0.18	0.32	0.25	0.10	0.39	2.73
Other real estate owned	5.12	0.96	0.54	0.22	0.44	1.12	8.40
Securities not in trading account*	124.83	83.19	77.89	33.71	67.39	53.01	440.02
Total liabilities	699.59	346.05	332.98	130.07	184.98	323.35	2,017.03
Total deposits	507.28	267.79	259.91	100.09	161.77	267.43	1,564.28
Domestic deposits	337.19	253.19	237.18	99.01	159.45	238.04	1,324.06
Loan loss reserve	11.97	4.25	4.22	1.76	1.81	7.30	31.30
Equity capital	54.42	27.72	27.94	11.59	16.42	30.13	168.23
Total capital	69.25	31.62	33.75	13.35	17.14	35.69	200.79
Balance Sheet Changes ($ Billions)							
Year-to-Date Changes:							
Assets	63.06	8.11	1.85	−1.25	−0.91	12.37	83.22
Loans	12.90	9.21	0.66	0.22	2.30	4.43	29.72
Noncurrent loans	−1.90	−0.55	−0.60	−0.23	−0.08	−1.65	−5.01
Other real estate owned	−1.03	−0.31	−0.37	−0.03	−0.16	−0.20	−2.09
Securities not in trading account*	0.67	−3.63	3.85	−0.81	0.70	2.13	2.91
Total liabilities	60.40	7.57	2.66	−1.38	−1.29	12.03	79.98
Total deposits	5.92	−0.63	−8.97	−5.93	−3.64	0.46	−12.80
Loan loss reserve	−0.04	0.01	−0.16	0.02	−0.02	−0.07	−0.26
Equity capital	2.66	0.54	−0.81	0.12	0.38	0.34	3.24
Total capital	3.66	1.46	−0.92	0.66	0.78	0.61	6.25
Second Quarter Changes:							
Assets	25.48	−0.20	−8.33	−1.17	−3.04	4.42	17.16
Loans	9.32	6.65	−1.84	1.35	2.78	7.73	26.00
Noncurrent loans	−1.44	−0.29	−0.50	−0.18	−0.04	−0.82	−3.27
Other real estate owned	−0.59	−0.17	−0.33	−0.01	−0.04	−0.16	−1.33
Securities not in trading account*	0.80	−3.42	−0.56	−1.15	−1.87	−0.56	−6.76
Total liabilities	23.70	−0.47	−6.99	−1.27	−3.18	4.03	15.83
Total deposits	7.54	1.18	−7.32	−4.10	−2.35	0.84	−4.21
Loan loss reserve	−0.02	−0.01	−0.24	−0.04	−0.01	−0.04	−0.36
Equity capital	1.78	0.26	−1.35	0.10	0.14	−0.04	1.33
Total capital	1.75	0.71	−1.66	0.29	0.29	0.25	1.62

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.

Note: 1994 data are preliminary.

Regulatory and Statistical Analysis (09/15/94)

Glossary

Definitions

Commercial Real Estate Loans: Loans secured by nonfarm, nonresidential properties.

Construction Loans: Loans for construction and land development.

Extraordinary Income, Net: Net after-tax income from events and transactions that are "unusual and infrequent."

Failed/Assisted Banks: National banks that have been closed by, or have received financial assistance from, the Federal Deposit Insurance Corporation (FDIC).

Gains on Securities Sales Net: Net pre-tax realized gains (losses) on securities not held in trading account.

Leverage Ratio: Ratio of estimated Tier 1 capital to estimated tangible total assets.

Loans: Total loans and leases less unearned income.

Net Loan Losses: Total loans and leases charged off (removed from balance sheet because of uncollectibility) during the period, less amounts recovered on loans and leases previously charged off.

Loan Loss Reserve: The allowance for loan and lease losses.

National Banks: Nationally chartered commercial banks, trust companies without deposits, nonbank banks, and credit card banks in the United States and its territories that are insured by either the Bank Insurance Fund or the Savings Association Insurance Fund of the FDIC and filed a call report.

Noncurrent Loans: The sum of loans and leases 90 days or more past due plus nonaccrual loans.

Net Interest Margin: Net interest income as a percent of average assets.

Other Real Estate Owned (OREO): Real estate acquired by a bank for debts previously contracted (i.e., foreclosed real estate). Also includes property formerly used or intended for use for banking purposes.

Regions: Northeastern (NE) — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont, Virgin Islands; Southeastern (SE) — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia; Central (CE) — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin; Midwestern (MW) — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota; Southwestern (SW) — Arkansas, Louisiana, New Mexico, Oklahoma, Texas; Western (WE) — Alaska, Arizona, California, Colorado, Guam, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming. Each bank in a multinational bank holding company is included in the region in which the bank is located.

Residential Real Estate: Loans secured by one- to four-family and multifamily (five or more) residential properties.

Risk-based Capital Ratio: Ratio of estimated total capital to estimated risk-weighted assets.

Securities Not in Trading Account: Total securities excluding those held in trading accounts. Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.

Total Capital: The sum of Tier 1 and Tier 2 capital reported on call report schedule RC-R.

Computation Methodology

Current quarter income statement items were calculated by summing the difference between the year-to-date and previous quarter numbers of each item for all banks that filed a current quarter call report. For performance ratios constructed by dividing an income statement (flow) item by a balance sheet (stock) item, the income statement item for the period was annualized (multiplied by the number of periods in a year) and the average of the balance sheet item for the period (beginning-of-period amount plus end-of-period amount divided by two) was used.

Is a Consolidated Banking Industry a More Efficient Banking Industry?

by Robert DeYoung and Gary Whalen
Bank Research Division

Introduction

From 1986 through the end of 1993, the number of commercial banks in the United States declined by over 20 percent, a reduction of more than 3,000 banks. Two main factors precipitated this consolidation. The lifting of within-state geographic branching restrictions intensified competition among banks, and financial deregulation intensified competition among different types of financial institutions. The resulting increase in competitive rivalry has forced banks to reduce their cost structures, price their products and services more intelligently, and improve the quality of their products and services. Assuming that antitrust laws and lower entry barriers work to prevent anti-competitive conduct, consumers will benefit from lower prices and improved service quality.

This consolidation occurred via three types of transactions. Bank regulators closed 974 banks due to insolvency, another 2,043 banks were converted to branches in corporate reorganizations of multibank holding companies (MBHCs), and 1,175 banks were purchased by other banks.[1] It is likely that banking consolidation through these three channels has enhanced industry efficiency. First, banks that are operated inefficiently presumably would be more likely to fail than efficiently operated banks. If this assumption is correct, failure reallocates scarce resources to banks that will use them more efficiently. Second, as legal restrictions on intrastate branching are removed, MBHCs can opt to reorganize by merging their affiliate banks—transactions that can produce cost savings through improvements in operating efficiency or elimination of duplicate overhead. Third, interfirm bank mergers can present opportunities to eliminate duplication, and in addition can allow banks to achieve more optimal size, better diversify across products or geographic markets, or generate profits by improving the operations at inefficient target banks. In this article, we investigate whether, and to what extent, each of these three channels of consolidation has enhanced the efficiency of the banking industry.

[1]There were also 1,091 new bank charters issued during this period. See Nolle (1994) for a more thorough description of the banking industry consolidation of the 1980s and 1990s.

Efficiency and Bank Failure

About one-quarter of the commercial banks that have disappeared since 1986 failed.[2] Logic suggests that inefficiently operated banks are more likely to fail than are efficiently operated banks. If this is true, attrition should improve the overall efficiency of the banking industry over time. Furthermore, as failure redirects valuable resources, including branch locations, deposits, and relationships with credit-worthy borrowers, from failed banks to surviving banks, the remaining portion of the industry should become stronger.

The most obvious characteristic of failed banks is not poor operating efficiency, however, but large amounts of nonperforming loans. Nonperforming loans in failed banks have typically been associated with regional macroeconomic problems. However, not all banks in troubled economic regions failed. Why did some banks become insolvent during these episodes, while others survived?

The key may be differences in the caliber of bank management.[3] Superior managers may not only run their banks in a cost efficient fashion, and thus generate large profits relative to their peers, but also impose better loan underwriting and monitoring standards than their peers, which result in better credit quality. Hence, we should observe high levels of cost efficiency coupled with low levels of nonperforming loans, in the same banks. Efficiently run banks should be less likely to fail during economic downturns because of larger capital cushions, more certain streams of interest income, and lower cost structures relative to their peers.

Testing this theory is difficult, because both inefficient operations and high levels of nonperforming loans drive up expenses. In addition to not producing any income for the bank, nonperforming loans can require banks to increase monitoring activities and incur loan workout expenses or expenses to sell or manage seized property. If a failed bank has unusually high expenses immediately prior to failure, it is not obvious

[2]In this paper, failure refers to a bank that has been declared insolvent by its primary regulator.
[3]See Office of the Comptroller of the Currency, *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks* (1988), which concluded that "the difference between the failed banks and those that remained healthy or recovered from problems was the caliber of management."

whether these "excess" expenses are due primarily to the administration of nonperforming loans or to inefficient operations.

Studies of cost efficiency in banks find that the most efficient banks have a substantial cost advantage over the most inefficient banks. After controlling for interbank differences in output mix, input prices, size, organizational form, and regulatory constraints, these studies typically find that the average bank incurs expenses that are between 20 and 30 percent higher than those incurred by its most efficient peers.[4] Expense differentials this large lead one to expect a higher rate of failure for cost inefficient banks.

This expectation is supported by the empirical literature on bank failure. Earlier bank failure studies tended to find that simple accounting measures of operating efficiency (e.g., the ratio of overhead expenses to total assets) and measures of nonperforming loans (e.g., the ratio of nonperforming loans to total loans) both are positively related to the likelihood of failure. More recent extensions of the bank failure literature replace the accounting measures of cost inefficiency with econometrically estimated measures that control for interbank differences in output mix, input prices, size, organizational form, and regulatory constraints.[5] When measured in this fashion, cost inefficiency is usually referred to as X-inefficiency, a concept originated by Leibenstein (1966).[6] Studies that employ measures of X-inefficiency also find positive relationships between inefficiency and the probability of failure. For example, a recent OCC study found that a measure of X-inefficiency calculated for banks in 1986 was a significant determinant of whether banks failed prior to the end of 1992.

In order to examine the interrelationships between loan quality, cost efficiency, and bank failure, we assembled a sample of 278 commercial banks that failed in either 1990, 1991, or 1992 and were at least six years old when they failed. Two pieces of information for each bank were examined in each of the six years leading up to its failure: a measure of nonperforming loans (NP) and a measure of X-inefficiency (Xindex). Xindex ranges from zero (for the most cost-inefficient bank) to one (for the most cost-efficient bank).[7] We separated the banks into six subsamples by geographic location—160 failed banks in southwestern states (Texas, Louisiana, and Oklahoma) and 118 failed banks from the other 47 states—and by year of failure (1990, 1991, 1992).

In each subsample, the mean values of NP and Xindex for the failed banks were compared to regional averages of NP and Xindex in each of the six years leading up to failure. The results fell into two types, represented here by Figure 1 (banks in the southwestern subsample that failed in 1990) and Figure 2 (banks in the non-southwestern subsample that failed in 1991).[8] In both of these figures, note that the failed banks were significantly less cost efficient than their non-failing peers in the year just prior to failure. Xindex averaged less than .20 (i.e., these banks were less cost efficient than over 80 percent of the banks in their regions) the year before failure. This extremely low level of cost efficiency just prior to failure is likely related to the extremely high levels of NP just prior to failure, which were significantly higher than the average for banks in their regions.

To disentangle unnecessary operational expenses (cost inefficiency) from increased expenditures due to administering problem loans, however, we must look beyond this one-year-to-failure data. In general, Xindex began to diverge from regional means between four to six years before failure, and was significantly less than regional averages three years prior to failure in all six subsamples. Nonperforming loans also began to diverge from the regional averages several years prior to failure. More importantly, cost efficiency in failed banks had a tendency to fall *before* nonperforming loans reached critical levels. The six subsamples fell roughly into the two patterns shown in Figures 1 and 2. In the first pattern (Figure 1), Xindex and NP decayed at about the same rate over time for the failed banks, and both measures became significantly different from regional means at about the same time. In the second pattern (Figure 2), Xindex became significantly different from regional means either one or two years earlier than did NP.

Although these results are crude, they are consistent with the "management quality" theory of bank failure extended above: banks with low levels of operating efficiency are also more likely to have poor underwriting and/or loan monitoring practices, resulting, eventually, in more bad assets and a higher likelihood of failure.

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[4] Berger, Hunter, and Timme (1993) and Evanoff and Israilevich (1991) contain good reviews of this literature.

[5] Demiguc-Kunt (1989) reviews the earlier literature. The later literature includes Barr and Siems (1994), Coyne, McManus, and Stagliano (1993), Lutton, DeYoung, and Becher (1994), and Wheelock and Wilson (1994).

[6] Leibenstein coined the term to describe cost overruns specifically attributable to management laxity at firms with market power. A variety of mathematical and statistical techniques have been used to measure X-inefficiency in banks, most of which compute the difference between a bank's actual costs and a "best practices" cost function, i.e., the lower bound of costs attainable only by the most cost-efficient banks. For a discussion of X-inefficiency in banking see Berger and Humphrey (1992).

[7] See DeYoung (1994) for a thorough description of the model.

[8] For complete results, see DeYoung and Whalen (1994).

Efficiency and Corporate Reorganizations

Roughly half of the reduction in commercial banks since 1985 can be accounted for by intra-holding company mergers of affiliate banks—in other words, corporate reorganizations. The effect of these reorganizations has been to reduce the number of affiliate banks in multibank holding companies (MBHCs), or in some cases to completely transform these firms into one-bank holding companies (OBHCs).

The choice of organizational form can be an important determinant of the efficiency of a company's operations. Observers often argue that the overhead required to maintain multiple affiliates can be a costly drag on performance. But, until recently, by choosing to organize as a MBHC a bank could avoid legal constraints on both the geographic scope of its operations and the breadth of its product offerings, advantages that could outweigh any intrinsic efficiency disadvantages.

Several recent developments have affected this tradeoff. The first is the easing in many states of restrictions on intrastate branching. Most companies responded, in varying degrees and at different rates over time, by consolidating all of their existing subsidiaries into branch banks.[9] This has not been the universal response, however, to the elimination of branching restrictions. Some MBHCs elected to merge only some, and in some cases none, of their bank subsidiaries. The variety of responses suggests actual or perceived differences in the efficiency benefits of complete consolidation.

The second development is the increase in competition in virtually all of the product and geographic markets in which banks operate. One of the effects of increased rivalry is pressure on banks to improve efficiency. The large number of intra-holding company consolidations that have occurred *independent of changes in branching laws* suggests that this type of reorganization is perceived by the companies involved as enhancing efficiency.

Intracompany consolidation will enhance organizational performance if it permits holding companies to significantly lower costs. Cost savings might materialize if organizations consisting of a single bank with branches are more able to exploit size-related economies than are MBHCs. Intracompany consolidation might also lower costs by facilitating improvements in X-efficiency. Banking researchers usually attribute interbank differences in X-efficiency to "superior management," but it is possible that some of this difference is attributable to differences in organizational form.

However, intracompany consolidation of subsidiary banks could have neutral or even adverse impacts on costs. MBHCs might realize the bulk of any potential scale economies by centralizing decisions and functions.[10] In this type of merger, branch offices typically are not closed—an often-cited source of cost savings in intercompany transactions. Gains in operating efficiency might be offset by increased "coordination costs." In addition, there is no guarantee that the quality of parent company management is significantly better than that of the bank subsidiaries.

It is also possible that intracompany consolidation could improve performance by increasing revenues. A consolidated organization might hold fewer low-risk, low-yielding assets than would separate affiliate banks, although an MBHC might also implement this reallocation by exercising centralized control over subsidiary bank asset/liability management. Intracompany consolidations are not likely, however, to enhance revenues through pricing changes, because they do not alter local market structure.

To provide insight on this issue we use a standard event study methodology to investigate the stock market response to the first public announcement by an MBHC of its intention to consolidate substantially all of its subsidiary banks, effectively transforming itself into an OBHC with branches. The sample consists of 39 MBHCs that decided to consolidate essentially all of their subsidiary banks within their headquarters state.[11] These consolidations are spread over a relatively long period, from 1974 through 1993.

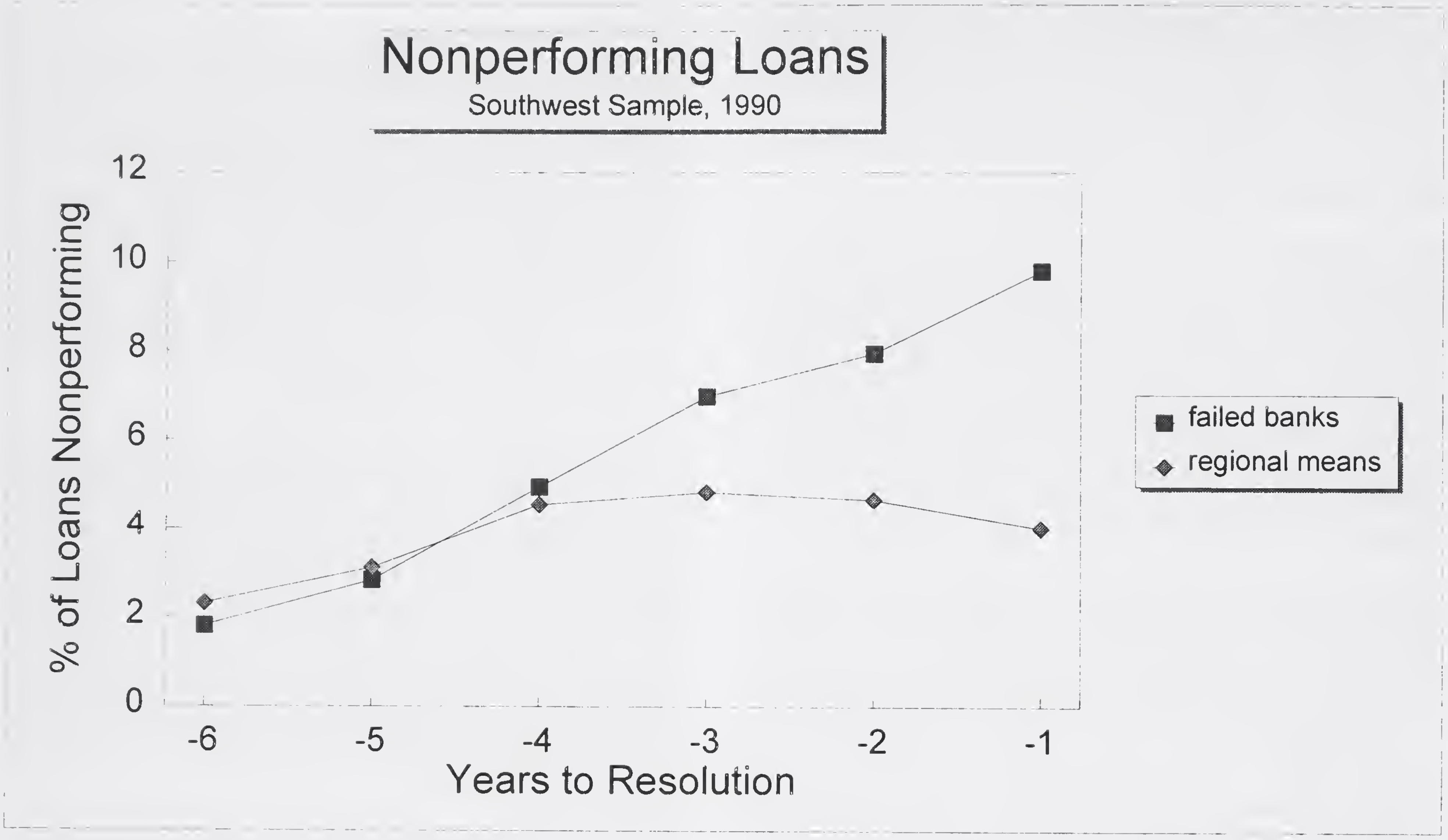
In an event study, a statistical technique is used to calculate daily "normal" stock returns for companies experiencing some common event. In this case, the event of interest is the announcement of a corporate reorganization. Estimated daily normal returns are then subtracted from the company's actual daily stock returns yielding a series of "abnormal" returns. After the abnormal returns for each company are calculated, they are averaged across the companies for each day

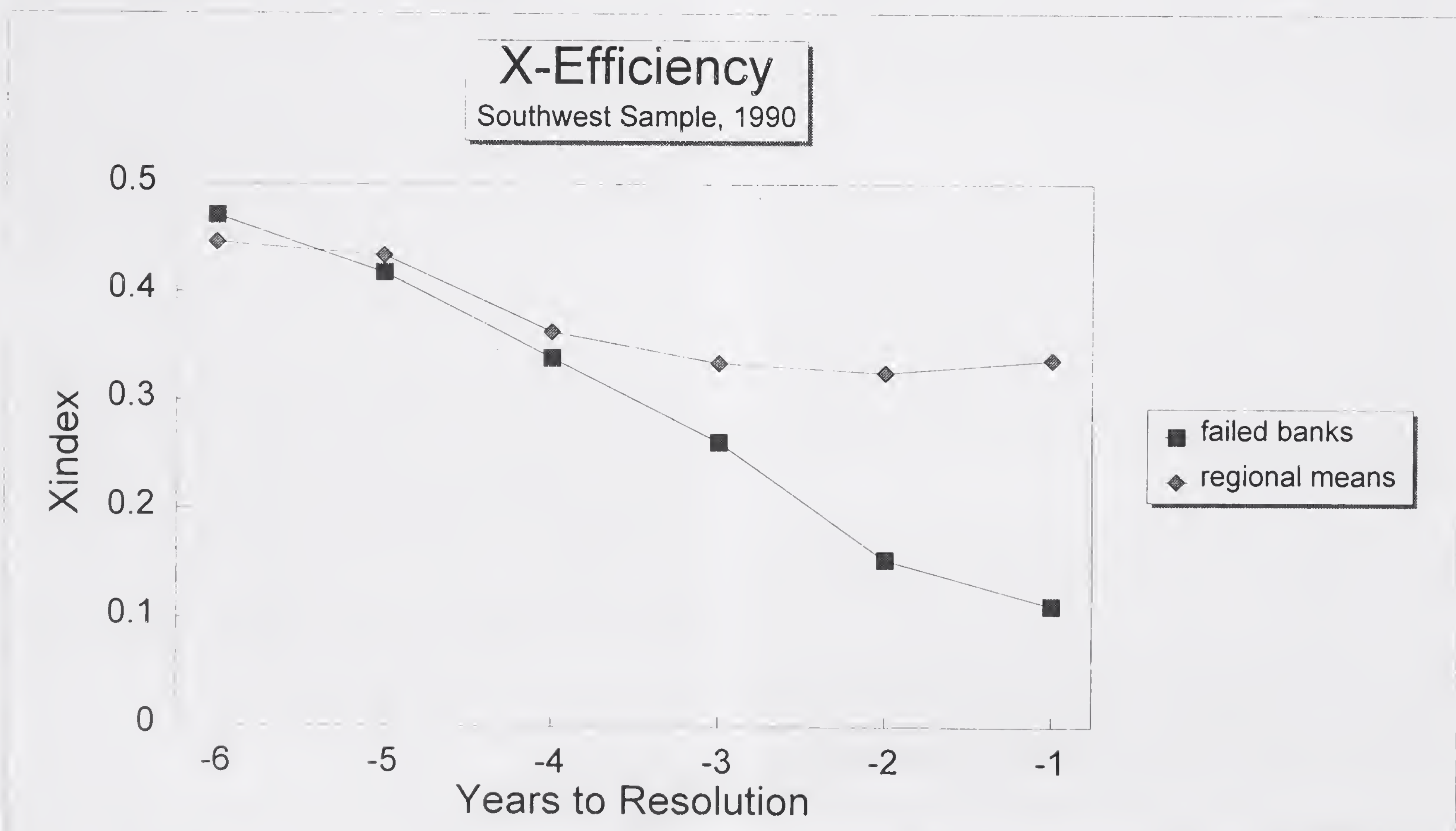
[9] It is not uncommon for companies to maintain two bank subsidiaries rather than one. Typically, one will be relatively small and have a different charter type than the larger subsidiary. This allows companies to fully exploit existing or future advantages associated with state or federal charters.

[10] For evidence on differences in holding company centralization, see Whalen (1981).

[11] Nine of these MBHCs owned subsidiary banks outside of their headquarters state that were not part of the announced reorganization. In addition, several of the holding companies in the sample consolidated all but one of their subsidairies into a large lead bank holding more than 90 percent of the banking assets of the company, leaving one smaller unconsolidated bank affiliate (typically with a different charter than the lead bank).

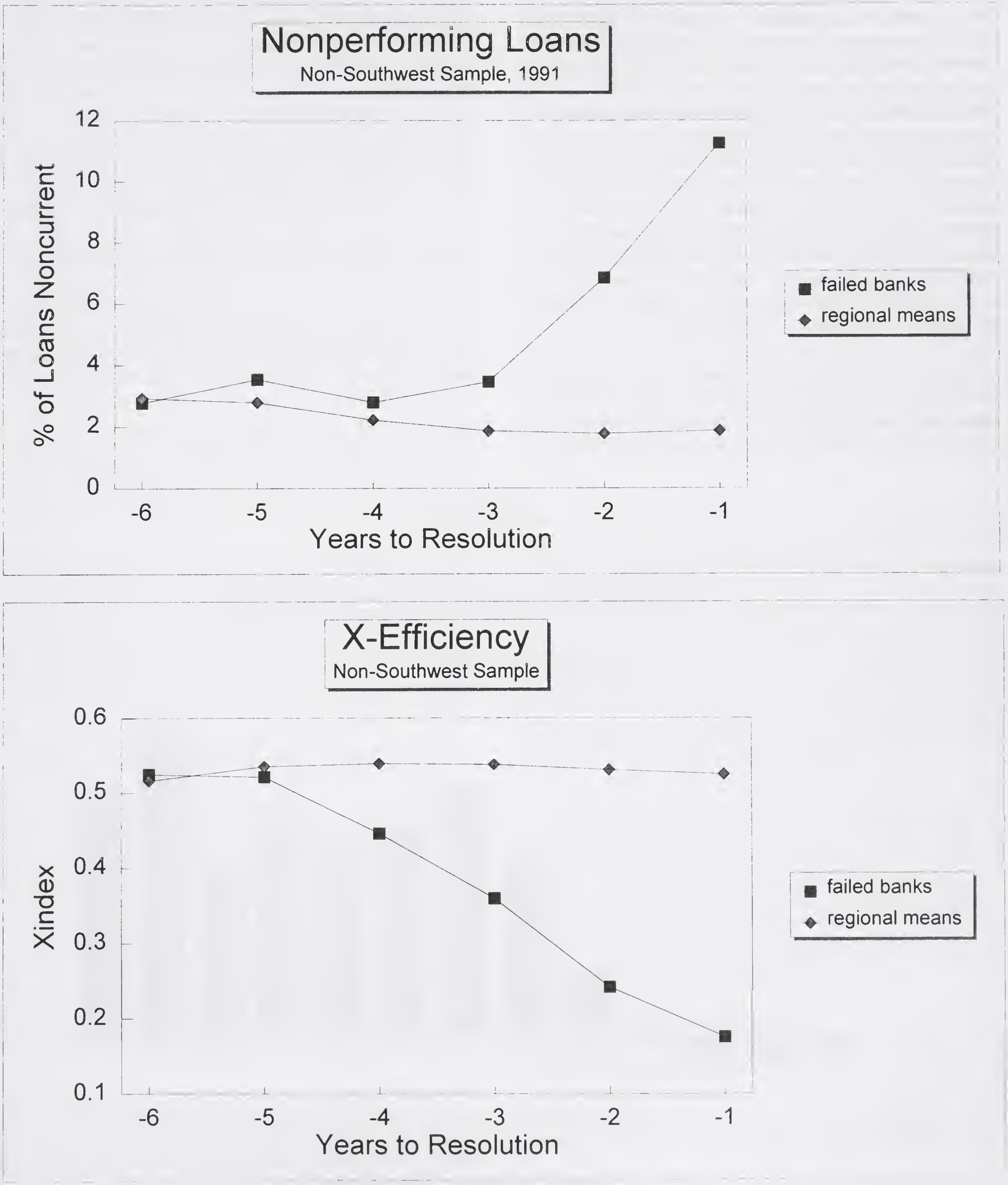
Figure 1





Source: DeYoung and Whalen (1994).

Figure 2



Source: DeYoung and Whalen (1994).

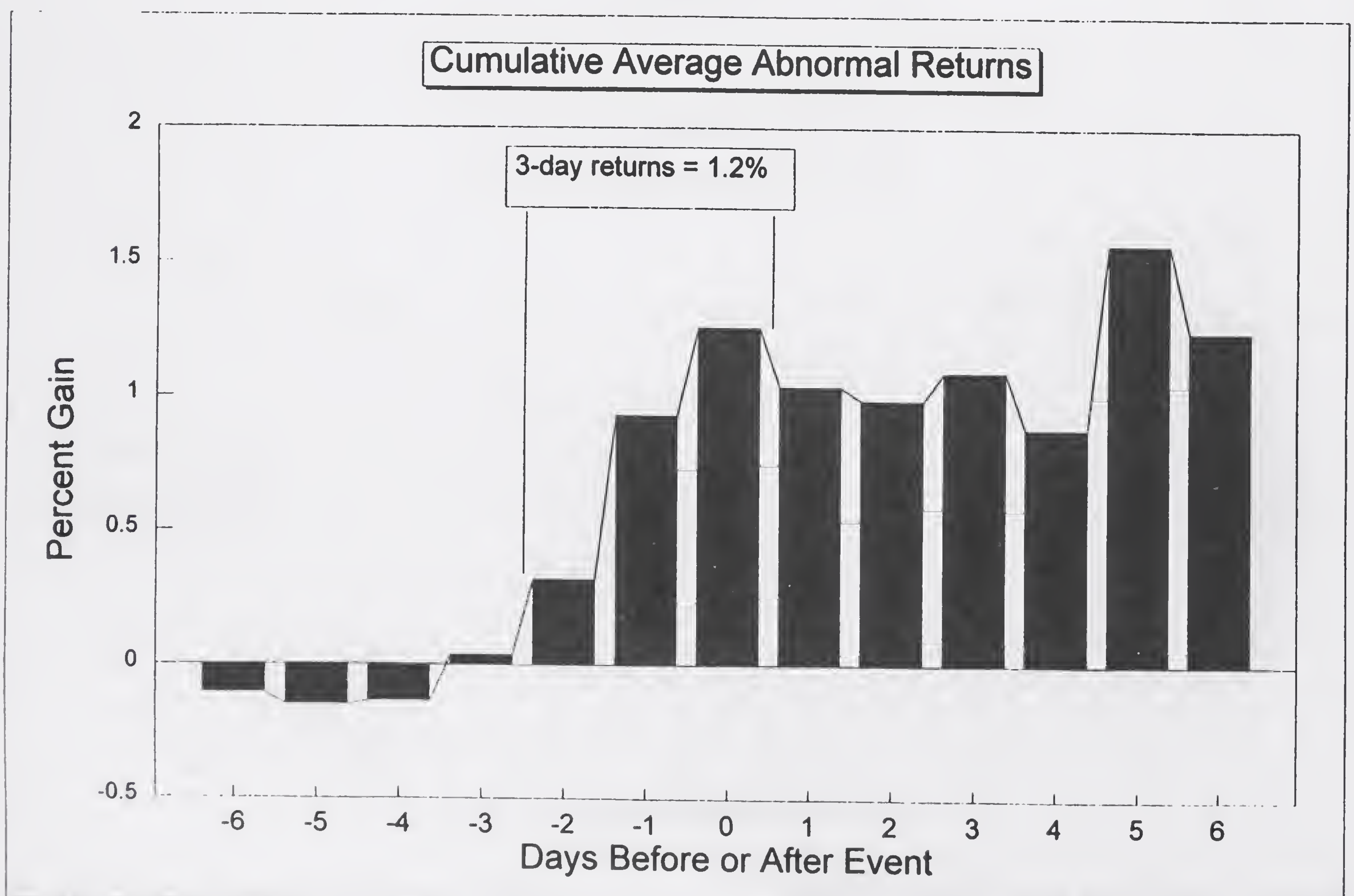
over a short period around the announcement day to produce a series of average abnormal returns (AAR). These average returns are then summed over various meaningful periods of time around the announcement day to produce cumulative average abnormal return (CAAR) measures. The sign, size, and statistical significance of the AAR and CAAR measures indicate the capital market's estimate of the event of interest. In this study, significant and positive average and cumulative average abnormal stock returns around the announcement date suggest that consolidation is expected to boost future profitability—through cost efficiencies, revenue increases, or both—thus enhancing the wealth of holding company shareholders. The absence of significant positive returns around the event date would suggest that investors believe that the optimal organization form can be reached without a complete consolidation of affiliate banks.

The key result is depicted in Figure 3, which shows the cumulative average abnormal returns calculated for the entire sample of 39 companies over the interval beginning six days before and ending six days after the announcement day.[12] The chart shows a series of positive average abnormal returns beginning two days before and ending on the consolidation announcement day. Over these three days the cumulative average abnormal return for the sample companies is roughly 1.2 percent. This increase in the market value of the sample companies is statistically significant. Furthermore, if we exclude the nine companies required by law to hold their interstate subsidiaries out of the announced consolidation, the three day cumulative average abnormal return figure is almost 1.5 percent and also is statistically significant. Thus, the empirical results are consistent with the hypothesis that consolidation generally enhances shareholder wealth, although the size of the performance effect is relatively modest.

The pattern and size of the abnormal returns around the announcement day varied considerably from company to company. Possible determinants of these differences were explored. Three variables were found to have a

[12]For complete results, see Whalen (1994).

Figure 3



Source: Whalen (1994).

significant impact on the abnormal returns for a consolidating company. First, returns to consolidation were related to the number of subsidiaries consolidated in a nonlinear fashion, with positive returns to an additional bank occurring only in reorganizations involving 16 or more banks. Second, larger returns were found for companies whose lead bank was larger than $1 billion but smaller than $10 billion in total assets. Third, returns to consolidation were negatively related to the average size of the nonlead bank subsidiaries that were consolidated. Returns were not significantly related to efficiency, profitability, the year of consolidation, or the extent of interstate banking operations.

The statistically significant and positive abnormal returns detected here suggest that intracompany consolidation *within* state boundaries can be expected to improve future profitability. Admittedly, these findings reflect investor expectations and are based on the analysis of a relatively small sample, but they are robust with respect to changes in estimation period and estimation techniques, are consistent with the intrastate trend toward branch banking (as opposed to retaining MBHC forms), and complement the empirical evidence reported by others using different samples and techniques.

While the analysis suggests that consolidation of holding companies *across* state lines could also yield efficiencies and enhance profitability, such a conclusion is tentative at best. It may be that further material performance gains might not be possible for interstate MBHCs that have already consolidated within the boundaries of each of the states in which they operate.

Efficiency and Bank Mergers and Acquisitions

About 25 percent of the commercial banks that disappeared from 1986 through 1992 were acquired by other banking organizations. Given the large amounts of cost inefficiency observed in the banking industry, one would suspect that cost reduction would be a strong motivation for this merger activity. The large number of studies that test this hypothesis, however, fail to find systematic evidence of postmerger efficiency gains. One possible explanation for these results is that many bank acquisitions may have been motivated by reasons other than cost savings.

The quest for efficiency gains is often listed as the primary motivation for bank mergers and acquisitions. Mergers might enhance the efficiency of some banks simply by making them larger. There is some disagreement, however, about the range of bank size over which scale economies occur. Although most studies estimate that banks reach minimum efficient scale (the size at which scale economies are exhausted) at between $100 to $200 million in assets, several studies have found additional scale economies for banks up to and over $1 billion in assets. The dollar estimates of the cost savings available from achieving efficient scale vary by study, from as little as 3 percent to as much as 40 percent of total costs.[13] Another way that bank mergers might generate cost savings is by reducing X-inefficiency at the acquired bank. If differences in the abilities of bank managers are the sources of these cost disparities, a merger in which managers and/or management practices at an X-inefficient target bank are replaced by the management practices of a more efficient acquiring bank might generate large cost savings. Studies suggest that these potential cost savings range from 20 percent to 30 percent of total costs at the most cost-inefficient banks.[14] Bank mergers might also generate a variety of efficiencies that result in enhanced revenues. For example, the postmerger bank may be able to offer a broader line of services at more geographic locations, thus offering "one-stop shopping" to its customers. A wider geographic reach may also better allow a bank to diversify its loan portfolio, thus reducing its susceptibility to localized economic downturns.

Banking companies might also be motivated to acquire other banks for a variety of reasons unrelated to efficiency. It is often easier to expand into new geographic markets with a market extension merger rather than through *de novo* entry. Market extension mergers may better situate a bank to take advantage of the relaxation of interstate branching restrictions. Banks might enhance their profitability via intramarket mergers that increase their market power. Finally, bank managers may simply be motivated to make acquisitions by their desire to run a larger banking empire.

A number of studies suggest that bank mergers tend to have the potential for significant improvements in cost efficiency or revenue efficiency. Hawawini and Swary (1990) found evidence from stock market returns that mergers of publicly traded banking organizations increase shareholder wealth. Although stock market studies measure only the market's expectation that mergers will improve future performance, these results might be interpreted as identifying mergers that, at the time of the acquisition, appear to have the potential for efficiency or profitability gains. Benston, Hunter, and Wall (1992) found that the acquisition price premium in bank mergers was positively related to acquiring bank efficiency (measured by the ratio of market to book value) and negatively related to target bank efficiency.

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[13] Evanhoff and Israilevich (1991) survey the banking scale economy literature.

[14] Berger, Hunter, and Timme (1993) survey the banking X-efficiency literature.

These results suggest that the market for corporate control of banks expected efficient managers to be able to improve the performance of targets previously run by inefficient managers. Shaffer (1993) simulated "megamergers" (mergers in which both banks have over $1 billion in assets) between actual banks under various assumptions about the postmerger transfer of efficiency. In hypothetical merger scenarios that paired cost-efficient banks with cost-inefficient banks, Shaffer found the potential for substantial potential savings from the elimination of existing cost inefficiencies.

Although these studies conclude that a potential for postmerger efficiency gains exist, there is little systematic evidence that this potential is translated into actual postmerger performance gains. A number of studies have examined premerger and postmerger financial ratios (e.g., operating margins, return on assets, noninterest expenses as a percentage of assets) and X-inefficiency. Most of these studies fail to find strong postmerger improvements in financial ratios or in X-inefficiency. The studies that do find postmerger improvements tend to find revenue improvements but do not find cost improvements.[15]

This evidence suggests that most merging banks are unable to turn potential cost savings into actual cost savings. Another likely explanation, however, is that cost savings might not have been the predominant motive for bank mergers during the 1980s. While the motivation for bank mergers in the 1990s may have shifted toward efficiency gains, merging banks in the 1980s may have been focussing on multiple objectives, including growth and geographic reach. When external growth is the motivation for making acquisitions, acquirers will likely target franchises with attributes that will ease the acquirer's entry into a new geographic market, such as extensive branch networks. These targets may in fact be cost inefficient (for example, the targets may be overbranched), and as a result appear to offer potential for efficiency gains. However, access to new customers is essential to establishing a new regional franchise, and cutting excess costs by closing branches will reduce that access.

If these observations are accurate, they suggest the possibility of a two-part strategy for mergers of nonaffiliated banks. In the first step, banks get a toehold through a market extension purchase of a bank with an extensive branch network. The acquiring company might continue for a while to operate the target as-is (i.e., with excess labor and excess branch locations remaining in place) in order to preserve existing customer relationships and establish brand presence in the new market. Once customer loyalty has been solidified, moves to cut costs—reducing office hours or eliminating branch locations—could be made at less risk to the value of the acquired franchise.

A recent OCC study contains some evidence consistent with this two-part merger strategy scenario. Table 1 reports a portion of this study's results for 105 acquisitions made by national banks in 1987 and 1988.[16] These 105 mergers were intrastate acquisitions of solvent target banks, made by acquiring banks that had not made any other acquisitions two years before, or three years after, the merger in question. Table 1 shows estimates of pre- and postmerger X-inefficiency for two categories of mergers: 44 acquisitions of unrelated banks, and 61 "acquisitions" of banks in the same holding company as the acquiring bank (i.e., corporate reorganizations).

Table 1 reports two measures of X-inefficiency for each category of mergers. "Xassets" equals X-inefficiency per dollar of assets. "Xindex" is based on Xassets, and ranges from 0.0 for the most X-inefficient bank to 1.0 for the most X-efficient bank. Both Xindex and Xassets were estimated separately for the target bank and the acquiring bank the year prior to the merger, and for the combined bank three years after the merger. To determine whether a merger enhanced efficiency, postmerger Xindex (or Xassets) was compared to the asset-weighted average of Xindex (or Xassets) for the acquirer and target banks.

The results are markedly different for the two merger categories. Premerger, the target bank was less efficient than its acquirer in 32 of the 44 mergers of unrelated banks. Acquiring banks averaged in the 56th efficiency percentile with an average of $.0089 of excess costs per dollar of assets. Targets averaged in only the 44th efficiency percentile with an average of $.0130 of excess costs per dollar of assets. In both cases, the means were different from each other at the 10 percent level of significance. Although these premerger results suggest that the mergers could have been motivated by the chance to make efficiency gains at a poorly managed target, the transactions did not systematically deliver postmerger efficiency gains.

In contrast, the premerger "target" affiliate was more X-efficient than its "acquirer" in the majority of intraholding company mergers. Furthermore, and consistent with the event study results reported in the previous section, postmerger X-inefficiency improved in 34 of 61 intraholding company mergers. Both Xasset and Xin-

[15] Studies by Berger and Humphrey (1992), Fixler and Zieschang (1993), Linder and Crane (1992), O'Keefe (1992), and Spong and Shoenhair (1992) are in the former group; Cornett and Tehranian (1992), Spindt and Tarhan (1991, 1993), and Peristiani (1993) fall in the second group

[16] See DeYoung (1993) for complete results.

Table 1
Pre- and Postmerger Efficiency of 105 Mergers in 1987-88

61 Intra-Holding Company Mergers:

	Mean Xindex	Mean Xasset
Premerger Acquiring Bank	0.4675	$0.00121
Premerger Target Bank	0.5239	$0.00112
Premerger Asset-Weighted Bank	0.4830	$0.00117
Postmerger Bank	0.5021	$0.00086

44 Acquisitions of Unrelated Banks:

	Mean Xindex	Mean Xasset
Premerger Acquiring Bank	0.5560*	$0.00089*
Premerger Target Bank	0.4368	$0.00130
Premerger Asset-Weighted Bank	0.5420	$0.00096
Postmerger Bank	C.5095	$0.00075

acquiring and target bank means differ at the 10 percent significance level.

Source: DeYoung (1993).

dex improved post-merger, although neither of these changes was significantly different from zero. Mean Xasset improved from $.0117 to $.0086 per asset dollar, and Xindex improved from the 48th to the 50th efficiency percentile.

These results suggest that intracompany mergers and intercompany mergers in the 1980s were motivated by different objectives, at least in the short run. Acquisitions of unrelated banks had the potential for cost efficiencies, but did not exploit this potential within three years. This is what we would expect to observe if the primary motivations are market extension and retention of new customers. In contrast, average postmerger X-efficiency improved in intraholding company mergers, although the change was not statistically significant. Because market extension is not a possible motivation for intracompany mergers, cost savings might be more likely in these mergers.

Industry Consolidation in the 1990s: Strategies for Banks

Overall, the evidence in the previous three sections suggests that the banking industry has become more efficient as it has consolidated.[17] We have presented evidence that cost inefficiencies can be a prelude to problem assets and insolvency in banks. We have also presented evidence that MBHC consolidations can increase the value of banking firms. Finally, we have presented evidence that mergers of unrelated banks may hold the potential for future gains in cost efficiency. These findings are consistent with much of the literature, and indicate that banking firms benefited when regulatory constraints on intrastate branching and organizational form were removed. Further, though perhaps smaller, benefits could accrue to multistate banking companies when full interstate branching becomes a reality.

Going forward, efficiency will continue to be of paramount importance to banks because it is likely that competition between bank and nonbank firms will become even more intense. Whatever banks do, they will have to do it more efficiently. The evidence presented above confirms the obvious, that inefficient business firms do not survive. Efficiency supports earnings and, if worse comes to worse, helps a bank weather potentially fatal economic shocks. Rationalizing existing corporate structure and expanding geographic reach—two of the predominant features of banking consolidation—are tactics that banking companies might continue to use to enhance efficiency.

But consolidation is not likely to be a panacea. Many MBHCs have already consolidated their operations within state boundaries, so further consolidation across state lines once interstate branching is allowed may not yield further efficiencies.[18] The evidence from mergers of unrelated banks suggests that although some banks have made postmerger efficiency gains, others have not. Furthermore, there is little hard evidence to explain the differences between these two groups.

Finally, it is possible to get carried away with efforts to cut costs. Cutting waste and duplication is an ongoing tactic that enhances profitability at every organization regardless of its competitive strategy. At some point, however, cutting costs can reduce the quality or range of services a bank can provide its customers. The objectives necessary to cut costs to the bone—fewer branches, shorter hours, fewer customer service representatives, lower salaries (and thus possibly less expertise)—can reduce a bank's abilities to attract and retain the business of high-margin customers who value personal relations and financial expertise.

[17] Our results are consistent with two other studies that also concluded that the banking industry as a whole became more efficient during the consolidation of the 1980s. Elyasiani and Mehdian (1990) found evidence that the industrywide production frontier shifted inward (i.e., productive efficiency increased) between 1980 and 1985. Although Bauer, Berger, and Humphrey (1993) find that measures of bank productivity and cost efficiency remained relatively constant across the 1980s, the authors conclude that unmeasured improvements in service quality left the consumer of banking services better off on balance.

[18] See Barton Crockett, "Cost Savings from Branching May Fall Short," *American Banker*, March 25, 1994

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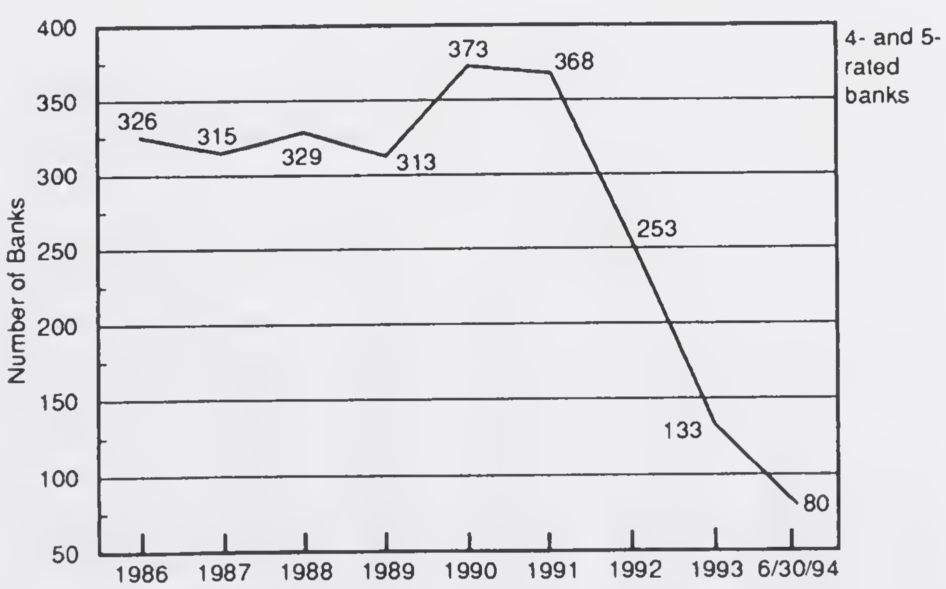
Special Supervision and Enforcement Activities

This section includes information on problem national banks, national bank failures, and enforcement actions. Data on problem banks and bank failures is provided by OCC's Special Supervision Division in Washington. Information on enforcement actions is provided by Special Supervision together with the Enforcement and Compliance Division of the Law Department. The latter is principally responsible for presenting and litigating administrative actions on the OCC's behalf against banks requiring special supervision.

Problem National Banks

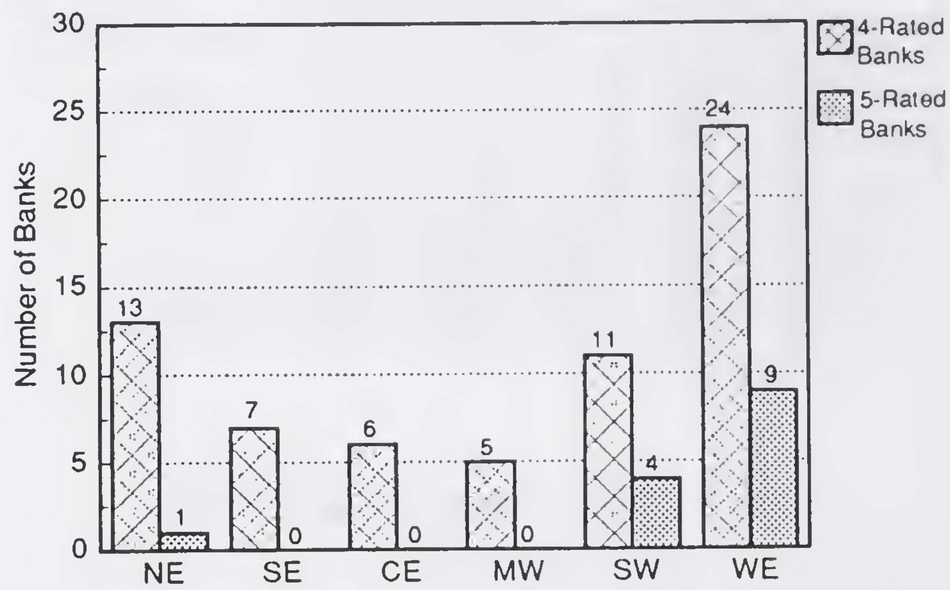
Problem banks represent approximately 2.5 percent of the national bank population. After reaching a high of 373 at the end of 1990, the number of problem national banks significantly declined to 80 as of June 30, 1994. The decline is a direct result of the improvement in the condition of the banking system brought about by an extended period of low interest rates and other favorable economic conditions. While the number of problem banks has continued to decline in all six districts, the Southwestern District has shown the most significant decline. The number of problem banks in the Southwest has declined by more than 90 percent since year-end 1991, from 209 to 15.

Problem National Bank
Historical Trend Line



Source: Special Supervision

Problem Banks by District
(as of June 30, 1994)

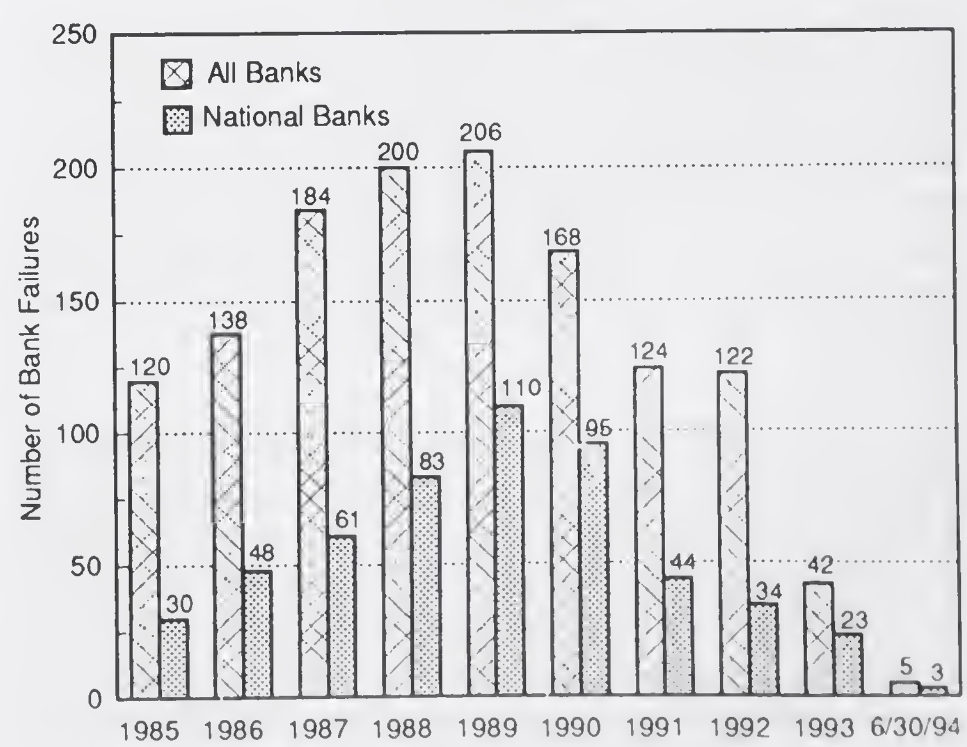


Source: Special Supervision

National Bank Failures

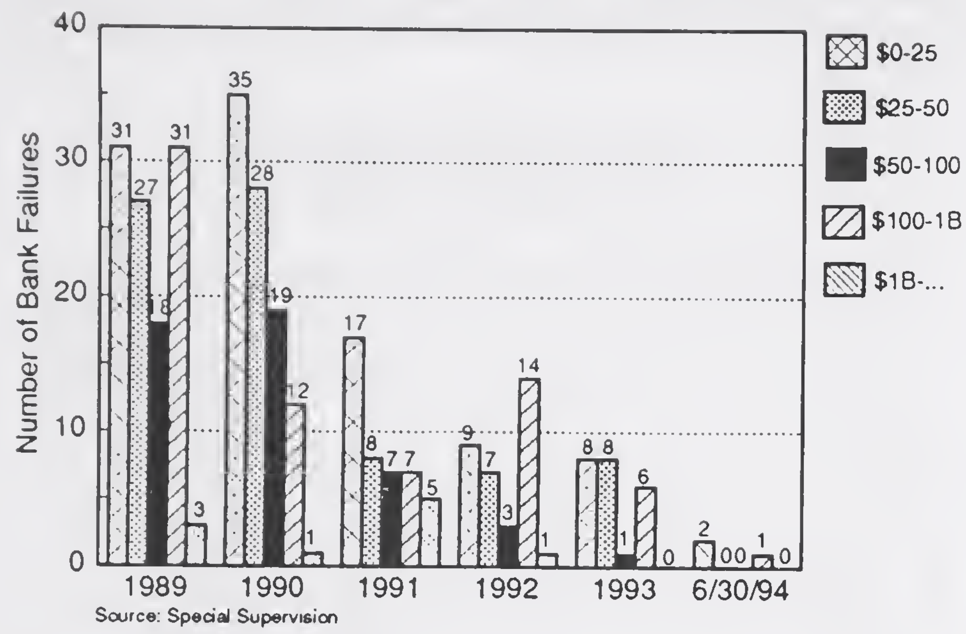
During the first six months of 1994, five commercial banks failed, of which 3 or 60 percent were national banks. At this rate, 1994 will have the lowest number of failures since 1981, when only two national banks failed. National bank failures this year have occurred in only two districts — one in the Midwest and two in the West. The average size of these failed banks was $54 million.

Bank Failures

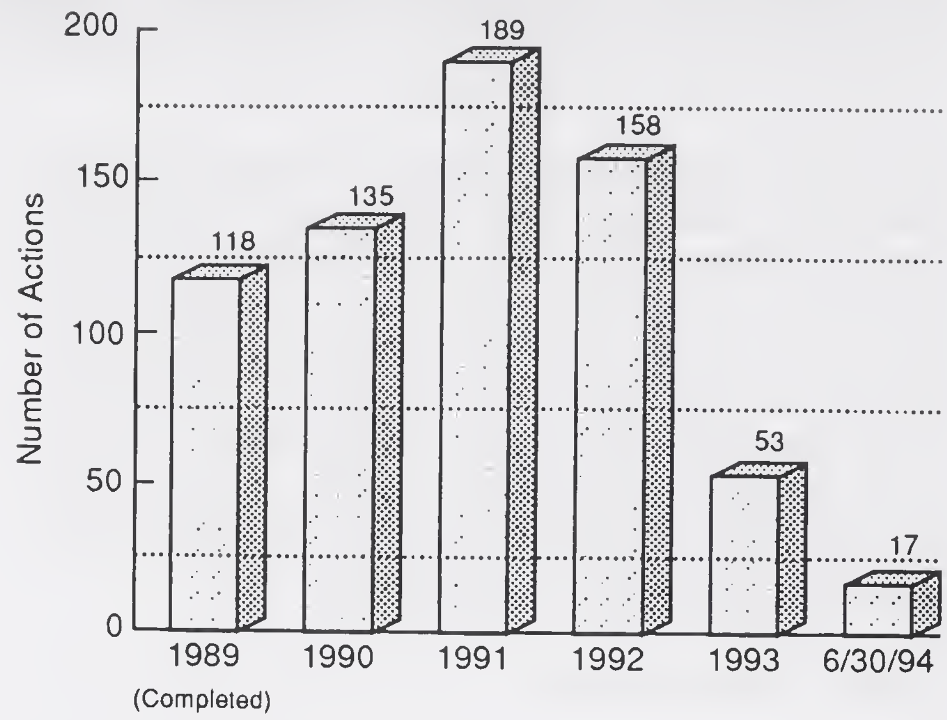


Source: Special Supervision

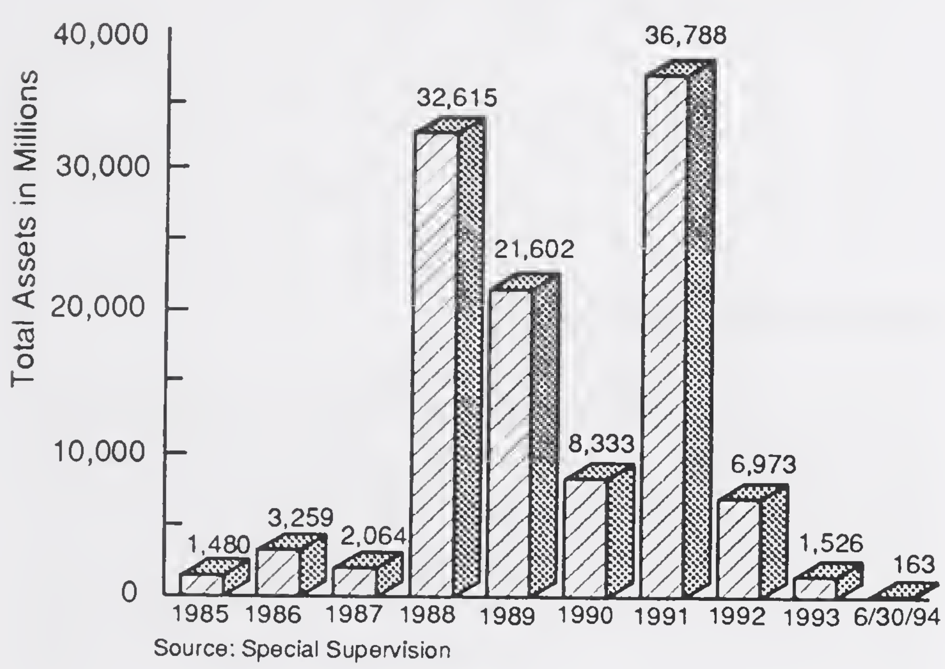
Failed National Banks
by Asset Size



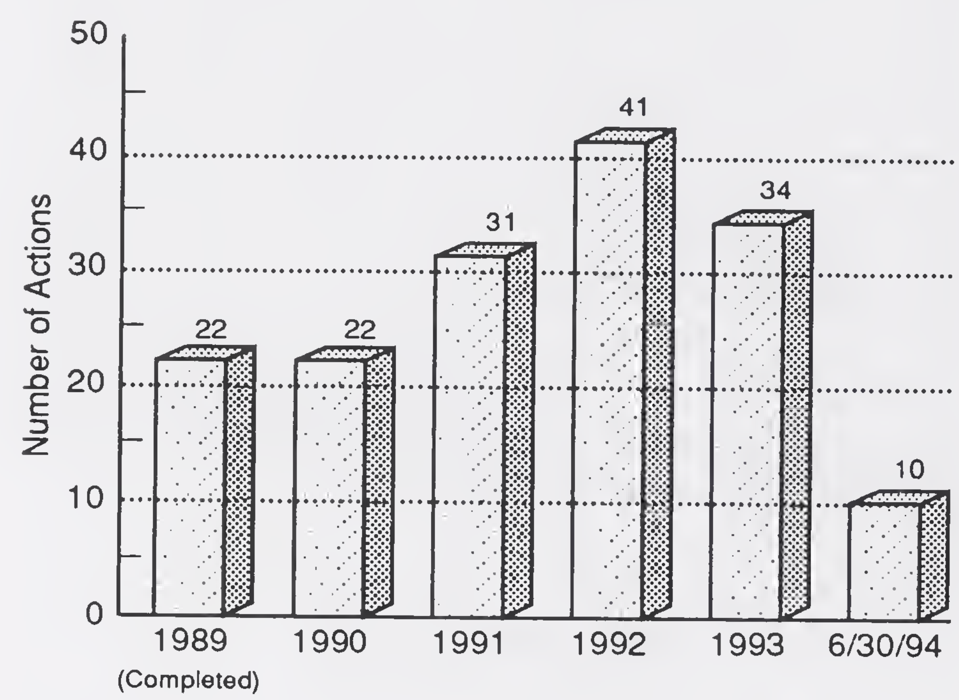
Commitment Letters



Dollar Volume of National Bank Failures
(in millions)



Memorandums of Understanding



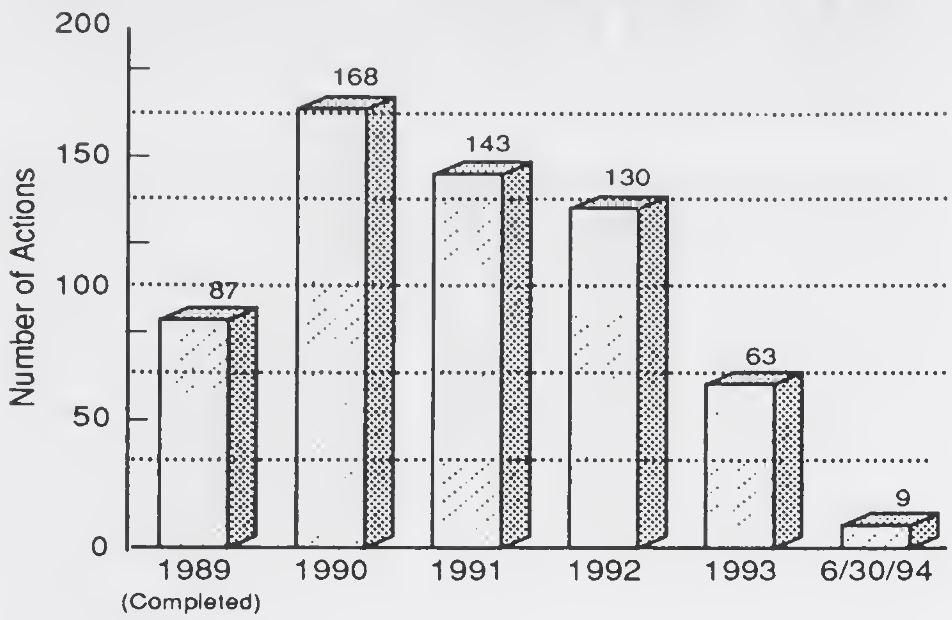
Enforcement Actions

The OCC has a number of remedies with which to carry out its supervisory responsibilities. When it identifies safety or soundness or compliance problems, these remedies range from informal advice and moral suasion to formal enforcement actions. These mechanisms are designed to achieve expeditious corrective and remedial action to return the bank to a safe and sound condition.

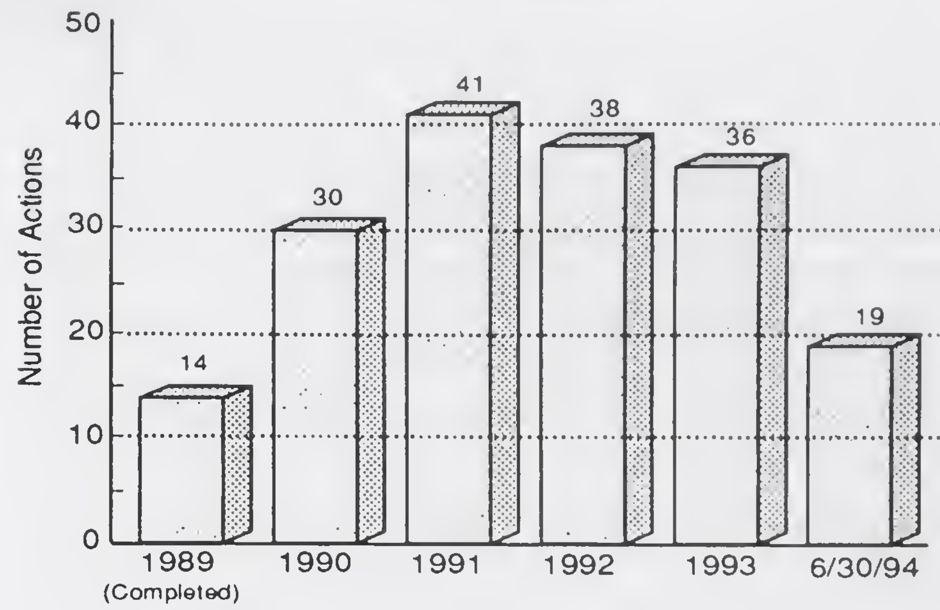
The OCC's informal enforcement actions include commitment letters and memoranda of understanding (MOUs). Informal actions are meant to handle less serious supervisory problems identified by the OCC in its supervision of national banks. While they are not legally enforceable, failure to honor informal actions will provide strong evidence of the need for the OCC to take formal action.

The most common types of formal actions issued by the OCC over the past several years have been formal agreements, cease and desist orders, civil money penalties (CMPs), and removals. Formal agreements are documents signed by a national bank's board of directors and the OCC in which specific corrective and remedial measures are enumerated as necessary to return the bank to a safe and sound condition. Cease and desist orders, sometimes known as consent orders, may be legally enforced. Like a formal agreement, these orders contain a series of remedial measures in article form. CMPs are authorized for violations of laws, rules, regulations, formal written agreements, final orders, conditions imposed in writing, and under certain circumstances, unsafe or unsound banking practices or breaches of fiduciary duty. The OCC occasionally is compelled to use removal orders to remove individuals, who have violated the law or acted in an unsafe or unsound manner, from the banking industry.

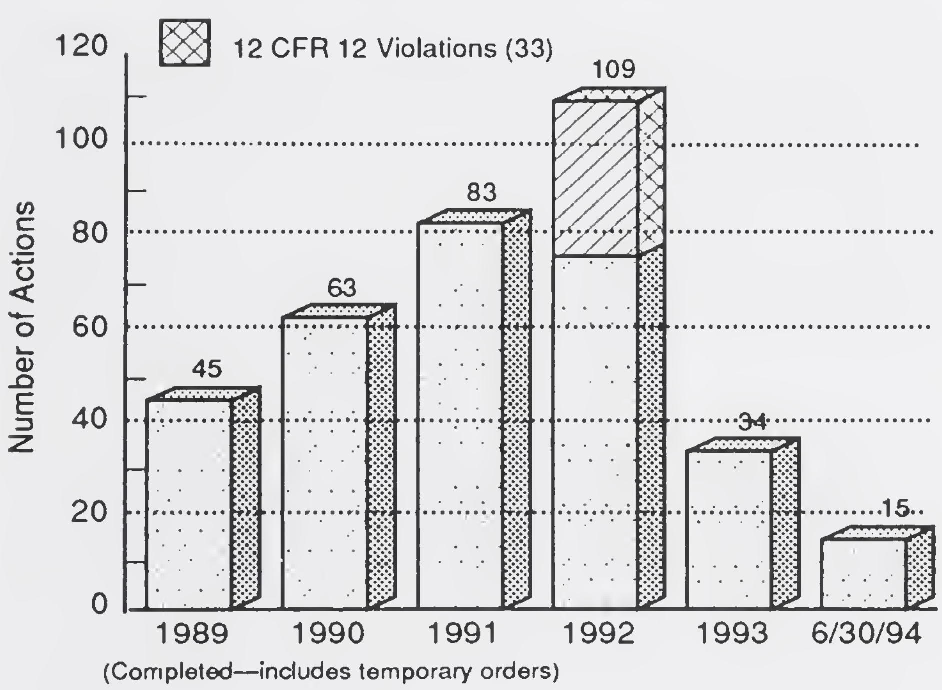
Formal Agreements



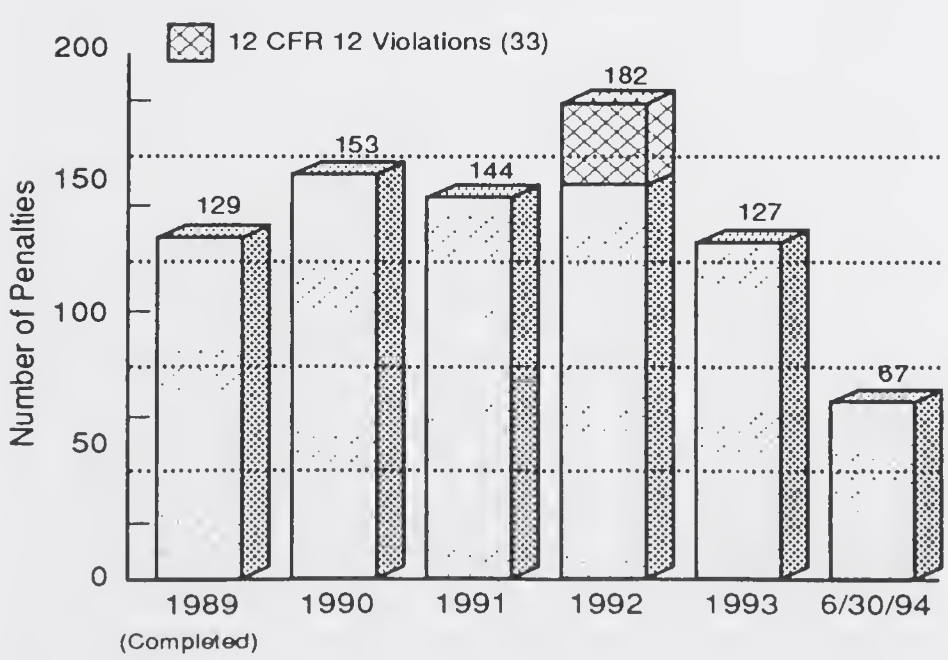
Orders of Removal



Orders to Cease and Desist



Civil Money Penalties



In addition, the OCC was given new authority under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to take certain Prompt Corrective Action (PCA) to resolve a bank's problems. Actions taken depend on a bank's level of capital. For instance, when a bank becomes undercapitalized it is required to submit a capital restoration plan (CRP). Depending on the severity of a bank's problems, a PCA directive can also be issued. The purpose of the PCA legislation is to resolve a bank's problems at the least possible long-term cost to the deposit insurance fund. During the first six months in 1994, eight banks were required to submit a capital restoration plan, and two PCA directives were issued.

Recent Corporate Decisions

On April 28, 1994, the OCC granted approval for First National Bank of Polk County, Copperhill, Tennessee, to relocate its head office from Copperhill, Tennessee, to Blue Ridge, Fannin County, Georgia (less than 30 miles) and to acquire two branches in Blue Ridge, Georgia, from NationsBank of Georgia, N.A. Although the bank's holding company already has a presence in Georgia, its Georgia banks are prohibited from branching in Fannin County, because Georgia's branching statutes prohibit cross-county branching. Prior to relocating, the bank chose to sell its Tennessee branches to an affiliate to eliminate any interstate branching concerns. The proposal is supported by solid OCC precedents and favorable court rulings.

On May 4, 1994, the OCC conditionally approved Mellon Bank's operating subsidiary notices to acquire The Dreyfus Corporation. The subsidiaries will engage primarily in investment advisory, brokerage, and administrative services involving about 130 Dreyfus mutual funds with about $80 billion in assets. The subsidiaries will not act as distributor of the mutual funds and will not engage in underwriting or dealing.

The approval subjects Mellon Bank and its operating subsidiaries to a number of conditions, including two supervisory ones concerning management oversight and compliance with each of the voluntary commitments contained in the bank's Policy Statement on Mutual Funds. The decision also emphasizes that the bank and the subsidiaries are subject to the *Interagency Statement on Retail Sales of Nondeposit Investment Products* issued by the federal bank and thrift regulatory agencies on February 15, 1994. In addition, the decision allows certain disclosure exceptions to the Interagency Statement for Dreyfus sales activities that are unrelated to bank sales, provided that the disclosures comply with Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) requirements and specifically mention the lack of FDIC insurance on nondeposit investment products. The OCC used the Mellon-Dreyfus decision to interpret the interagency statement's provision on the suitability of banks' adopting standards identical to the NASD's suitability rule. Accordingly, national banks and their operating subsidiaries have the same information-gathering responsibility and suitability analysis requirements with respect to money market funds as imposed by NASD's rule.

On April 12, 1994, the OCC approved notifications from PNC Bank, N.A., Pittsburgh, Pennsylvania, and Chase Manhattan Bank of Connecticut, N.A., Bridgeport, Connecticut, to offer asset management services for unaffiliated, nondepository third-party investors who have purchased asset pools from other depository institutions (not the Resolution Trust Corporation or Federal Deposit Insurance Corporation). OCC's decisions relating to asset management have evolved since the first such decision on October 18, 1990. Initially, the OCC had approved specific classes of institutions for which a bank could manage assets, including RTC- and FDIC-related transactions. The current decisions shift OCC's interpretation from classes of institutions to the activity, i.e., asset management, and the types of assets to be managed. These approvals also break the perceived RTC/FDIC public benefits and correspondent connection and expand the OCC's official position on asset management activities conducted by national banks. Banking Circular 254, which details OCC's prior position, will be revised in light of these decisions.

On June 10, 1994, the OCC granted final approval for Industrial Bank of Washington, Washington, DC, which is one of only two banks still operating in the District of Columbia that was chartered under the original DC Banking Code, to acquire two branches of John Hanson Federal Savings Bank, Greenbelt, Maryland, from the RTC. To facilitate the acquisition, the RTC granted a temporary override of Maryland's branching law, pursuant to Section 217 of the Financial Institutions Reform, Recovery, and Enforcement Act.

On May 18, 1994, the OCC granted conditional approval for American Community Bank, Lima, Ohio, to acquire an operating subsidiary to engage in the sale of fixed and variable-rate annuities from a place whose population is less than 5,000. To voluntarily comply with Ohio's insurance code, the operating subsidiary has an unusual ownership structure in which an individual (an officer of an affiliate bank) will own all of the operating subsidiary's voting stock and the bank will own only nonvoting shares. This structure is necessary because Ohio's law requires the stock of an incorporated insurance agency to be owned by a "natural person." The OCC opined that since the bank would have control of the insurance agency through a contract with the individual owning the voting stock, the bank's nonvoting shares could be deemed to be "voting stock" for purposes of 12 CFR 5.34. Since the bank voluntarily structured the proposal to comply with Ohio law, the OCC did not address issues relating to whether, and to what extent, national banks are required to comply with such state law provisions.

On May 26, 1994, the OCC conditionally approved a CEBA credit card bank for Whirlpool Financial Corporation. The bank is to operate under the title of Whirlpool Financial National Bank, New Castle, Delaware. The approval is subject to the standard conditions the OCC places on CEBA credit card banks, and a condition that requires the bank to enhance its CRA program. Whirlpool was also informed that the bank should not use the proposed point-of-sale terminals to approve credit until OCC's Law Department has had an opportunity to review the proposal for possible branching implications.

On May 12, 1994, the OCC disapproved the proposed acquisition of a troubled institution. Several of the proposed acquirers had violated national banking laws previously. In addition, the financial statements provided by some of the acquirers were found to be false and misleading.

On June 28, 1994, the OCC granted conditional approval for The First National Bank of Southeastern Ohio, Caldwell, Ohio, to establish three operating subsidiaries to engage in the sale of insurance, as agent, and of fixed- and variable-rate annuities. The insurance activities will be conducted from locations with populations of less than 5,000. As in the American Community Bank proposal discussed above, to voluntarily comply with Ohio's insurance code, the operating subsidiary that is selling life insurance has an unusual ownership structure in which an individual will own all of the operating subsidiary's voting stock and the bank will own only nonvoting shares. This structure is necessary because Ohio's law requires the stock of an incorporated insurance agency to be owned by a "natural person." The OCC concluded that since the bank would have control of the insurance agency through a contract with the individual owning the voting stock, the bank's nonvoting shares could be deemed to be "voting stock" for purposes of 12 CFR 5.34. Because the bank voluntarily structured the proposal to comply with Ohio law, the OCC did not address issues relating to whether, and to what extent, national banks are required to comply with such state law provisions.

On June 15, 1994, the OCC conditionally approved a CEBA credit card bank for Fingerhut Companies, Inc. Fingerhut is a direct marketing company that sells a broad range of consumer products and services via catalog, television and other media. The bank will be operated under the title of Direct Merchants Credit Card Bank, National Association and is to be located in Salt Lake City, Utah. The approval was subject to the standard conditions the OCC places on CEBA credit card banks.

On June 7, 1944, the FDIC established a national bridge bank to facilitate the acquisition of Meriden Trust Company, Meriden, Connecticut, under the cross guaranty provisions of the Financial Institutions Reform, Rrecovery, and Enforcement Act. Meriden is a trust bank affiliate of Central Bank, Meriden, Connecticut, which failed two years ago.

Decisions Related to the Community Reinvestment Act

On April 8, 1994, the OCC granted conditional approval to four applications filed by Commerce Bank, National Association, Cherry Hill, New Jersey to establish four branches in Somers Point, Atco, Sicklerville, and Haddonfield, New Jersey. The OCC made the approvals conditional because the bank had demonstrated a less than satisfactory performance under the Community Reinvestment Act (CRA) during a recent OCC examination of the bank. The OCC required Commerce Bank to submit a comprehensive program to improve its CRA performance to the district office. Approval is also conditional upon the bank achieving a satisfactory CRA performance.

On April 20, 1994, the OCC granted conditional approval to an application filed by The National Bank of Vernon, Vernon, New York, to establish a branch in Oriskanny Falls, New York. The OCC made the approval conditional because the bank had demonstrated a less than satisfactory CRA performance during a recent OCC examination of the bank. The OCC's conditional approval requires The National Bank of Vernon to achieve a satisfactory CRA performance.

On June 10, 1994, the OCC granted conditional approval to First National Bank in Newton, Newton, Illinois, to effect a corporate reorganization by merging with and into First Interim National Bank in Newton, Newton, Illinois. The approval was conditional because of the bank's less than satisfactory performance under the Community Reinvestment Act during a recent OCC examination. The bank's less than satisfactory performance was found in the board's limited supervision of the CRA process and activities, the board's limited involvement in ascertainment of community credit needs, failure to develop a complete CRA program, and lack of proper training to ensure that lenders are not engaging in discriminatory lending practices. The OCC's approval requires First National Bank in Newton to achieve a satisfactory CRA performance.

Appeals Process

Case 1: Appeal of Determination that Appraisal Function Lacks Independence

Background

A bank appealed its examiner's determination that its commercial real estate appraisal function lacks independence because of the reporting lines within the organization. The unit reports to a vice chairman who also has responsibility for the credit extension, collection, and lending policy functions. The bank's appeal to the supervisory office was decided in favor of the examiner.

Discussion

The function in question reports administratively to a senior vice president responsible for collateral appraisal and control. That individual reports to an executive vice president with responsibility for credit policy, commercial credit training, portfolio analysis, and reporting. The executive vice president reports to the vice chairman responsible for credit risk management.

The examiner's decision was determined as follows:

Both 12 CFR 34.45 and Banking Circular 225 (dated December 21, 1987) require that appraisers be independent of the lending, investment, and collection functions and not involved, except as an appraiser, in federally related transactions. The September 28, 1992 revised issuance of BC-225 expands on this standard by stating, "In order to avoid potential conflicts of interest, staff appraisers should not be supervised by loan underwriters, loan officers or collection officers." The regulation and circulars note that in some instances it may be necessary to use a qualified individual who is not independent of the lending function to perform an appraisal, but this exception is primarily intended for cases where the bank is small and lacks the resources to retain qualified, in-house independent appraisers. The examiner decided this bank was large enough and sophisticated enough to afford qualified in-house appraisers, reinforcing the need for independence.

Although the vice chairman is not actively involved in the daily credit approval and appraisal activities of the bank, he is ultimately responsible for credit policy, the credit approval process, and collection and appraisal functions. It is through his authority that the potential for a conflict of interest could occur.

The bank based its appeal on the following points:

1) No one in this reporting chain has any lending or revenue generation responsibilities. No staff appraiser is supervised, controlled, or influenced by anyone who has direct loan underwriting, account management, or collection responsibilities.

Line appraisers and reviewers are insulated from potential negative influences by reporting to a regional manager who, in turn, reports to a chief appraiser. The chief appraisers report directly to the unit head. Independence is further supported by two senior positions strategically placed in the unit's organization: the managers of compliance and training, and quality assurance and audit. This is in strict compliance with BC-225 (REV) which stipulates that "staff appraisers should not be supervised by loan underwriters, loan officers, or collection officers."

2) As a diversified financial services provider, the credit function of this bank encompasses the strategic management of risk beyond the more traditional narrow confines of "credit" risk relating to loans. Transactional credit approval is totally separated from the credit policy, portfolio management, problem loan workout, and derivative and trading products administration activities within this credit risk management function.

3) Direct management and experienced senior level oversight of the appraisal function has a necessary and logical place within the bank's strategic credit risk management group. This arrangement ensures the unit's independence from line management, which is challenged and given incentives to produce volume and expand market share, and from transaction approvers, who, hypothetically, could succumb to direct or indirect pressure to influence the appraisal process.

4) There has never been any indication or suggestion that actual or implied pressure or influence has ever been exerted on the unit in question. A different reporting channel simply to avoid the "credit" sphere would negate the protective features mentioned above and the efficient service the bank has been providing through this arrangement.

Conclusion

The current structure of the bank's real estate appraisal function fulfills the mandate for independence as required by the regulation and banking circulars. Nothing

was discovered to arouse concern that appraisal independence was compromised or threatened. Further, the independence of the process as currently structured is not unduly dependent on the persons presently performing those duties. Assuming competent replacements are chosen, independence should not be adversely affected by personnel changes.

Note: This decision is unique to the specific facts and circumstances of the case decided. As such, it should not be viewed as precedential. The issue of independence is currently being reassessed, and more specific guidance will be provided.

Case 2: Appeal of CRA Rating

Background

A bank filed a second-tier appeal of the rating and findings of OCC's Community Reinvestment Act examination report. The bank's CRA performance was rated "Needs to Improve Record of Meeting Community Credit Needs" based upon alleged substantive violations of the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA). The bank claims that OCC criticism rests on an incomplete and inaccurate understanding of what actually occurred at the bank. Further, apart from the fair lending violations, the examiners found the bank's CRA performance to be equal to or better than the performance that had been rated "Satisfactory" at the previous CRA examination. At their exit meeting with the board of directors, the examiners specifically confirmed that the bank would have received a "Satisfactory" CRA rating had it not been for the fair lending violations.

Examiners identified three instances of single women who applied for loans reported under the Home Mortgage Disclosure Act (HMDA) in which "protected income" was not taken into account by the bank. Two of the applications were for home improvement and the third was for money to purchase a house. The protected income involved child support, social security benefits received on behalf of a dependent child, and part-time wages. All three applications were denied. The examiners also identified a case in which the protected income of the primary applicant, Veterans Administration disability, was taken into consideration by the bank when it made the credit decision. That application was approved.

The bank responded that only one of the three instances appeared to contain an error under ECOA and this error was due to the lending officer's honest misunderstanding of a nuance in the protected income rules. The loan officer believed that social security income of the applicant's dependent son had to be excluded from consideration, analogous to the mandatory exclusion of the income of a nonapplicant spouse. In the other two cases, the bank claimed there was no Regulation B error. One of the applicants was disqualified on the basis of a previous bankruptcy filing, without respect to income. The other applicant's protected income had been considered, but had not been properly recorded on the internal HMDA reporting form.

At the examiners' request, the bank conducted its own file search for the 24-month period prior to the date of examination to identify all applicants affected by the practice. Of the 156 approved and denied individual female applicants, management uncovered six instances (including the three cases identified above) in which protected income was not taken into account in the loan applications of single women. These applications were either not approved or were approved for a lesser amount than that requested. Seven additional approved loans were identified in which the applicant(s) had protected income that was not included in the HMDA register and therefore was not taken into account when making the credit decision. The bank also took affidavits from each of the loan officers who made the 13 loans noted above.

Discussion

The ECOA states that ""[i]t shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction... on the basis of race, color, religion, national origin, sex or marital status or age (provided the applicant has the capacity to contract)..." 15 U.S.C. 1961(a).

The FHA further provides that "[i]t shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any persons in making available such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin." 42 U.S.C. 3605.

Regulation B, 12 CFR 202.6(b)(5), states that "[A] creditor shall not discount or exclude from consideration the income of an applicant or the spouse of an applicant because of a prohibited basis or because the income is derived from part-time employment or is an annuity, pension, or other retirement benefit...When an applicant relies on alimony, child support, or separate maintenance payments in applying for credit, the creditor shall consider such payments as income to the extent that they are likely to be consistently made."

A violation of 12 CFR 202.6 does not automatically result in discrimination that would violate ECOA. How-

ever, the failure to take a protected class of income into account can result in a pattern of loan denials that would demonstrate a pattern of discrimination, in violation of ECOA.

The facts in this case do not support a discrimination case based on overt discrimination, as there is no instance of overt refusal to lend to a woman or an unmarried person. At issue is whether the facts support a finding of disparate treatment. In the fair housing context, the presence of any one individual of a protected class who is treated differently from any one, similarly situated member of the control class is sufficient to establish a disparate treatment case.

Conclusion

The referenced violations of ECOA did occur. The documentation was not sufficient to support the claim that the instances identified were simply the result of HMDA reporting errors. After conducting its own file search, the bank initiated corrective action by sending letters to certain applicants resoliciting credit applications. These letters include the statement, "A review of our files indicates that we did not take the child support (or social security benefits) listed on your application into consideration when making our credit decision." Based on these letters to the affected applicants, the bank's assertion that HMDA record-keeping and reporting errors created the appearance of infractions of ECOA appears contradictory. Also, there was not supporting information bolstering the loan officers' recollections (as reflected in the affidavits included with the appeal) that protected income was considered in their credit underwriting and decision-making process for the referenced sample of loans.

However, despite the fair lending violations, a rating of "Satisfactory Record of Meeting Community Credit Needs" was assigned by the Ombudsman's Office. The quality of all other aspects of the bank's overall CRA performance justified this rating.

Note: A bank's fair lending performance materially affects its assigned CRA rating. All such decisions are unique to the facts and circumstances of each case and must be decided on an individual, case-by-case basis.

Case 3: Appeal of Examiner's Direction to Defer Recognition of Gains

Background

A bank appealed its examiner's direction to defer recognition of all gains on the sale of Small Business Administration (SBA) loans for 90 days. A provision in the sales agreement provides for recourse if the borrower fails to make the first three payments after sale of the loan.

The bank claims its accounting practices are in accordance with generally accepted accounting principles (GAAP EITF 88-11). The bank's accounting firm takes the position that the risk of returning a premium is minimal, which has been proven through historical experience. Further, OCC confirmed by letter that there is no question these transactions should be reported as sales, not financings. The bank believes the Instructions for the Consolidated Report of Condition and Income (call report) state clearly that if the transaction is a sale, the gain or loss must be recorded immediately. Finally, the bank states that there is no published rule or regulation specifically requiring that gains on sales of SBA loans be deferred. The principle is discussed in unpublished interpretations and opinions. The bank believes that reliance upon the case-by-case implementation of unpublished rules results in inequities and material inconsistency in the reporting of financial results among peer banks.

The effects of complying with the examiner's direction are as follows:

- The bank will fall below the "well-capitalized" level.
- The bank will find itself in noncompliance with the capital requirements of its formal agreement.
- The bank will have to recognize expenses incurred in the current quarter and will be unable to recognize the related income.

The bank also appealed the examiner's requirement that the bank amortize loan packaging fee income, net of associated expense, over the life of the loan. It feels the loan packaging fee has no relationship to whether or not the loan is made, and it is not required of the customer to have a loan packaged by the bank. The customer may use an outside packager, in which case, no fee is charged by the bank. If the bank provides the packaging service, the fee is charged to cover its expenses and make a slight profit for that service. The package belongs to the borrower, who may take the package to another bank to obtain the loan if desired.

Discussion

Although the accounting and reporting treatment required for regulatory reporting is generally consistent with GAAP, there are exceptions where the agencies have concluded a more stringent policy is necessary

for supervisory reasons. The policy on assets transferred with recourse is one such area. The call report instructions state that the general rule for reporting transfers ("sales") of assets is for purposes of reporting to the bank supervisory agencies and agency determination of capital adequacy; it is not intended to establish general accounting principles or to establish presumptions about the legal or contractual rights of the parties to the transfer.

Transactions involving the "sale" of assets are reported either as financing or sales transactions. The general rule is that a transfer of loans, securities, receivables, or other assets is to be reported as a sale of the transferred assets by the reporting selling institution and as a purchase of the transferred assets by the reporting purchasing institution *only* if the transferring institution:

(1) retains *no* risk of loss from the assets transferred resulting from any cause *and*

(2) has no obligation to any party for the payment of principal or interest on the assets transferred resulting from:

- default on principal or interest by the obligor of the underlying instrument or from any other deficiencies in the obligor's performance;
- changes in the market value of the assets after they have been transferred;
- any contractual relationship between the seller and purchaser incident to the transfer that, by its terms, could continue even after final payment; or
- any other cause.

According to the instructions to the call report, "If risk of loss or obligation for payment of principal or interest is retained by, or may fall back upon, the seller, the transaction *must* be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller."

However, in recognition of the unique structure of SBA loans, the staffs of the banking agencies concluded that the optional repurchase provision contained in the loan agreements would not prohibit sales treatment, provided the refundable premium on the sale is deferred until the refund provision expires. This modification is consistent with the accounting for loan securitization sales transactions involving the use of an escrow or spread account to absorb losses. In other words, by deferring the premium income until it becomes nonrefundable, a bank may recognize a sale for regulatory purposes.

Conclusion

The bank must defer SBA premium income for 90 days according to the interagency guidelines. The temporary change in capital categories resulting from this treatment cannot be avoided. Capital adequacy encompasses many other qualitative factors in addition to Prompt Corrective Action (PCA) capital category (i.e., earnings, credit risk, funding risk, growth, management, and board supervision, etc.). The district will emphasize, as the bank should, the bank's overall capital adequacy and capital planning efforts versus a temporary change in capital categories. The supervisory office agreed to give consideration to the amount of SBA premium income that will become available for earnings during the upcoming quarter in their qualitative assessment of the bank's overall level of capital sufficiency. This does not relieve the legal requirement that the bank has to comply with the mandates imposed by the PCA section of the Federal Deposit Insurance Corporation Improvement Act and the capital levels specified in the bank's formal agreement.

The agencies recognize that this policy on recourse needs to be reviewed. Currently, an interagency working group, under the auspices of the Federal Financial Institutions Examination Council, is studying the entire recourse issue in great detail. The group has already solicited public comment on the issue and expects some proposals for change in the near future.

Due to the immateriality of the bank's packaging fees in relation to total income, the bank need not amortize loan packaging fees over the life of the loan.

Case 4: Appeal of Violation

Background

The Office of the Ombudsman received an appeal letter on behalf of a bank that was cited for a violation of 12 CFR 9.12 and Opinion 9.3900. The bank invested trust funds into two mutual funds that are advised by an investment advisory firm in which a bank director, who also serves on the bank's trust committee, holds a 5.23 percent interest. Neither fund nor the investment advisory firm is affiliated with the bank. The funds were invested without obtaining prior written authorization.

First, the bank does not believe that the relationship between the bank and the minority investment by the bank director constitutes an affiliation sufficient to create a problem under 12 CFR 9. None of the interests delineated in Section 9.12(a) are affected in this case:

(1) The trust funds are not invested in stock or obligations of the advisor. The fund may terminate its relationship with the adviser upon 60 days notice without penalty at any time.

(2) No property is acquired from affiliates of the bank or their directors, officers, or employees. The adviser does not sell fund shares; such shares are distributed directly by the funds.

(3) The bank receives no advantage from the sale of the funds nor does the advisor.

The bank does not believe that the bank director's minority interest of 5.23 percent is sufficient to create a conflict of interest or a sufficient interest to fall within the prohibitions of Section 9.12. The bank is not purchasing services of the advisor, it is purchasing shares of the funds, which are unaffiliated with the bank and in which no bank director has an interest. Neither does the bank believe that the bank director's service on the bank's trust committee should weigh heavily in the decision. Even if a director has a conflict of interest, traditional corporate practice, which is recognized by OCC, holds that by abstaining from any participation in the discussion of, or vote upon, a matter in which such director has an interest, such director may thereby avoid an impermissible conflict of interest under applicable law. The bank cites *Alabama Code*, Section 10-2A-63, 12 CFR 215.4(b)(i), Section 7.5217(a) and *Alabama Code*, Section 10-2A-21(d).

Second, the bank believes that the provisions of the local law, in this case the *Alabama Code*, were expressly intended to permit a bank to rely on such provisions in order to invest trust funds in mutual funds that are advised by the bank or its affiliates. *Alabama Code*, Section 19-3-120.1, expressly governs trust investments in mutual funds, and expressly authorizes investments in mutual funds advised by bank affiliates. In the bank's view, 19-3-120.1 is more than sufficient for purposes of 12 CFR 9.12(a). The absence of any "affiliation" between the bank and the funds raises a question in the bank's mind as to whether reliance on the statutory authorization is even necessary. Although the terms "connection" and "interest" from Section 9.12(a) are broad, the bank believes that with respect to trust mutual fund investments by a trust department, the connection or interest must be an "affiliation" in order to even need the protection provided by 19-3-120.1 for purposes of 12 CFR 9.12.

Finally, the bank believes that recent OCC decisions allowing bank acquisitions of companies that act as advisers to mutual funds expressly recognized that investment companies (mutual funds) are separate and distinct from their advisers (decision to charter J. & W. Seligman Trust Company, N.A. and decision to charter Dreyfus National Bank & Trust Company). The bank also cites First Union's acquisition of Lieber Asset Management Corporation (93-ML-08-023) and Mellon Bank's acquisition of The Dreyfus Corporation (93-NE-08-043 and 93-NE-08-044).

Discussion

The legal issue raised by this appeal involves the conflict of interest that may exist given the investment of trust assets in mutual funds advised by a company in which a bank director owns stock. In pertinent part, Section 9.12(a), provides:

> (a) Unless lawfully authorized by the instrument creating the relationship, or by court order or by local law, funds held by a national bank as fiduciary shall not be invested in stock or obligations of, or property acquired from, the bank or its directors, officers or employees, or individuals with whom there exists such a connection, or organizations in which there exists such an interest, as might affect the exercise of the best judgement of the bank in acquiring the property, or in stock or obligations of, or property acquired from, affiliates of the bank or their directors, officers or employees.

The OCC's regulation is intended to reflect and require for national banks the duty of undivided loyalty, a basic principle of trust law followed throughout the United States. Leading commentators on trust law emphasize the importance of the duty of loyalty and the expected adherence to the high standard. The focus of the duty of loyalty is to deter fiduciaries from entering into positions involving conflicts of interest.

In the present situation, although another company is investment advisor to the mutual funds and not the bank, the relationship of the bank director to the advisory company falls under the circumstances proscribed by the language of 12 CFR 9.12. Here, at least one bank director has some type of ownership in or control over the advisory company. The fees received by the investment advisor depend in part on the assets invested in the mutual funds. As such, the owners of the advisor have an interest in the investments in the mutual funds. As directors of the bank, this individual is responsible for directing and reviewing the fiduciary powers of the bank. Accordingly, in the ombudsman's view this situation falls within the scope of the 12 CFR 9.12 prohibition regarding the investment of funds in stock or obligations of organizations in which there exists such an interest as might influence the best judgment of the bank.

As provided by the language of 12 CFR 9.12(a), a self-dealing transaction generally is permissible only

when specifically authorized by the trust instrument creating the relationship, where a court order authorized the specific transaction, or where local law allows the otherwise prohibited practice. In this bank's situation, it is not argued that the trust instruments specifically authorize the investment of trust assets in mutual funds that are advised by a company owned in part by directors of the bank. Nor is there any court order authorizing the transactions in question. While the Ombudsman's Office is not aware of any Alabama statute that expressly states that a bank may invest trust monies in mutual funds that are advised by a company owned in part by directors of the bank, *Alabama Code*, Section 19-3-120.1 (1993), does authorize banks acting as fiduciaries to invest in mutual funds that the bank or an affiliate advises or provides other services:

> The fact that such fiduciary or any affiliate thereof is providing services to the investment company or investment trust as an investment advisor, ... custodian, transfer agent, registrar or otherwise, and is receiving reasonable remuneration for such services, shall not preclude such fiduciary from investing in the securities of such investment company or investment trust; provided, however, that with respect to any fiduciary account to which fees are charged for such services, the fiduciary shall disclose (by prospectus, account statement or otherwise) to the current income beneficiaries of such account or to any third party directing investments the basis (expressed as a percentage of asset value or otherwise) upon which the fee is calculated.

Arguably, this section thereby authorizes investment in the mutual funds where a greater conflict exists than that in the bank's situation. Since the Alabama legislature specifically authorized investment in mutual funds where the bank or an affiliate acts as investment advisor or provides other services, it is at least arguable that the statute may include the situation where bank directors own shares in the advisor even though not enough shares to be an affiliate. If the directors owned a greater percentage of the stock (creating an even more direct conflict), and such ownership triggered affiliation between the bank and the advisor, then the conduct would be expressly authorized by the language of the statute. However, we are not aware of any cases interpreting the meaning of the statute and there is no official legislative history.

Conclusion

Because this is a question of law without any precedential or official legislative history, the Ombudsman's Office chose not to render an immediate decision. The bank was asked to seek a formal opinion from the Alabama attorney general regarding the meaning and intent of the statute. Although not binding for this Office, under the rules of statutory construction, the formal opinions of state attorneys general are normally given considerable deference. While waiting for receipt of that opinion, the bank was advised not to make any more investments in the mutual funds in question and to notify the ombudsman of the attorney general's opinion.

For reasons unique to the State of Alabama, the bank requested as an alternative, and the ombudsman agreed to accept, a similar ruling from the Alabama superintendent of banks. Kenneth R. McCartha, superintendent of banks for the State of Alabama, confirmed the bank's position in a letter dated August 12, 1994, providing his official opinion regarding the meaning and intent of the Alabama statute. In light of the history of the legislation and the language of *Alabama Code*, Section 19-3-120.1, Superintendent McCartha concluded that banks located in Alabama, in the exercise of their fiduciary or trust powers, are specifically authorized by 19-3-120.1 to invest in mutual funds where such banks, or their respective officers, directors, or shareholders have an affiliation or lesser interest in a mutual fund, or investment advisor, or other service providers to a mutual fund.

Therefore, the ombudsman concluded, after careful consideration of all the facts, that the most reasonable interpretation of Part 9 provides an exception for the conflict in question. This decision is unique to the facts and circumstances of this situation and local law. This in no way establishes OCC precedent regarding conflicts of interest. Notwithstanding this conclusion, the Alabama statute requires the fiduciary to provide disclosure to the current income beneficiaries and/or any third parties directing investment of the basis on which any investment advisory fee or other fee is calculated. The bank did not make these disclosures and therefore the cited violations must stand. Although the bank may continue investing fiduciary monies in the mutual funds in question, the appropriate disclosures must be made in accordance with the local law.

Case 5: Appeal of CRA Rating

Background

A formal appeal was received concerning a bank's Community Reinvestment Act (CRA) rating of "Needs to Improve Record of Meeting Community Credit Needs." Approximately 80 percent of the bank's business is in the trust/fiduciary area with the remainder in commercial banking. The bank's only office is located in a large downtown metropolitan area.

The appeal states that the fundamental flaw of the performance evaluation (PE) is captured in the following comment:

> There are no legal or financial impediments that inhibit the bank's ability to meet the credit needs of its community. The bank has made a modest response to help meet the credit needs of the community. There is a strong need for affordable housing and small business loans within the bank's delineated community. Considering this, management and the board actions designed to meet these needs have thus far been fairly narrow in scope. The bank has not sufficiently pursued alternative means by which it can help meet the community's credit needs.

The appeal then states the preceding is manifestly inaccurate as the bank has made more than a modest response to ascertain and to help meet the credit needs of its local community and has pursued many alternative means by which it could help meet the community's credit needs. The bank states that the needs of the local community are of such an obvious nature that the credit needs and demographics within a two-mile radius surrounding the downtown area have been well identified by the bank and steps have been taken to help address these needs, within the limits of the expertise and resources of the bank.

The appeal goes on to state that although only approximately 20 percent of the bank's loans are made within its delineated community, this does not prove that the bank in any way fails to address its CRA responsibilities. The bank is heavily involved in outreach programs of various sorts. Many such involvements will lead (and are leading) to extensions of credit in the local community, as has been shown through association with two organizations. Because the bank conducts private banking business it is natural that the extensions of credit it is willing to make available would mostly fall within geographic areas that are not low- to moderate-income. This is not due to avoidance of CRA responsibilities. At the same time, as the PE discussed, the board and management are looking for credit needs and are open to additional extensions of credit to credit-worthy borrowers within the bank's local community. This is proven in that the bank is making such loans as the opportunities arise.

The appeal states the bank feels that the rating is based upon the following conclusionary statements in the performance evaluation:

- The bank's contact with community groups is inadequate.
- The board's involvement in the CRA oversight process is inadequate.
- The bank has no written marketing or advertising programs.
- The bank has made limited efforts to extend loans for small business, home improvement, and housing rehabilitation throughout its community.

The appeal lists several reasons why the bank does not feel that these are accurate statements. These reasons are summarized below:

- Prior to the start of the examination, one of the bank's officers had been invited to be on the board of directors of an organization that was helping an area within the bank's delineated community rebuild. After the examination another officer became a senior advisor to this organization.
- An officer and director of the bank joined the board of a home for children and identified the need for a loan, which the bank made after the examination.
- The bank gave a donation and a large working crew to a nationwide organization that rehabilitates homes of low- or no- income residents, including those in the bank's local community.
- An officer has established a relationship with a real estate developer to develop a financing proposal term sheet to be used to obtain financing to develop low- and moderate-income housing in a low- and moderate-income area within the bank's delineated community. The bank feels that this effort will result in a large loan in which the bank would possibly participate in addition to giving ongoing consulting.
- Members of the board of directors have been working with a minority-owned bank regarding the establishment of a trust capability for the bank with this bank acting as the "back office" for the other bank.
- Bank officers and directors are working with a group in developing and proposing a structure for a syndicated credit facility to be used by a fund established to lend to small businesses in a low- and moderate-income area.
- The board has been involved in the establishment of policy for the CRA area and has met

all of the technical requirements of the act. The majority of board members are officers at the bank. On an informal basis, the officer/directors constantly discuss with one another the activities that each is undertaking, including activities for CRA. The appeal states that they do not believe that the judgment that such involvement is inadequate is fair because of the fact that the director/officers are intimately involved in the process on a daily basis. Due to the small size of the staff (five commercial bank officers), each of the officers knows what the others are doing with respect to CRA and they discuss these matters on a continuing basis.

- The bank has not spent heavily for written marketing or advertising programs. However, recently the bank has funded the placement of its name on an assistance van that tours regularly through the bank's local community, disseminating financial, legal and regulatory information to small business owners. (Although this advertising was implemented after the examination, negotiations for such advertising were being conducted prior to the writing of the PE.) The board of directors does not feel that it would be prudent from a safety and soundness aspect for a bank that allocates only 20 percent of its business to commercial banking to spend large amounts of money on advertising.

- As pointed out in the PE, prior to the examination the bank made some home purchase loans in its CRA delineated community and joined a referral program comprised of five local banks and one savings and loan association. In addition, the bank purchased several SBA-guaranteed loans, approximately a third of which are in the city where the bank is located. Since the examination, the bank purchased an additional pool of direct SBA loans, all assisting businesses within the city in which the bank is located.

- Before the examination began, the bank joined with other financial institutions with a mission of making loans for multiple-unit buildings in its CRA community. Subsequent to the examination this resulted in the bank committing funds for 30- year loans for three low-income multifamily projects.

The appeal concludes by pointing out that the PE observes that the bank's credit products and services are suited to the bank's market niche. The bank feels this is appropriate, as the bank specializes in trust services and is designed to conduct private banking, which constitutes 80 percent of the bank's business and reflects the expertise of the bank's personnel. Since only 20 percent of the overall business is dedicated to commercial banking and the bank cannot be all things to all people in its local community, the bank feels it has chosen credit products and services with which the bank has expertise and from which the community benefits. The appeal states that nowhere in the statute or regulations of CRA does it require that the bank make loans within its local community for which it has no expertise, even if there is such a need in the community, as long as the bank is helping to fulfill other community credit needs for which it does have expertise. The appeal emphasizes that the bank has geared its CRA-related credit products and services to meet the credit needs of the low- and moderate-income areas by, among other things, lending to financial intermediaries and participating in loan consortia or pools that lend directly to low- and moderate-income areas.

Discussion

Although some institutions may be subject to statutory or regulatory constraints that prevent them from operating as a "full service" bank, other banks may choose to voluntarily limit or specialize their services to target particular markets. This is fine; however, such banks have the same continuing and affirmative obligations as a "full service" institution to help meet the credit needs of the entire local community consistent with safe and sound operations. A bank's self-imposed service or market limitations may not be used as justification for a failure to define its local community or to help, directly or indirectly, in meeting the credit needs within that community, including low- and moderate-income neighborhoods.

Whether or not a bank operates as a "full service" entity is not a determining factor in evaluating its CRA performance. Every bank should be able to demonstrate that it is fulfilling its CRA responsibilities, either within the context of its chosen service specialties or in other ways. The final measure of CRA performance is in the credit benefits accruing to the bank's local community as a result of that bank's activities, irrespective of the vehicle by which those credit benefits are provided.

Question 29 in the January 1993 OCC book *An Examiner's Guide to Consumer Compliance* discusses the Federal Financial Institutions Examination Council's (FFIEC) view on what, in addition to traditional direct lending activities, an institution can consider in meeting obligations and responsibilities under the CRA. Examples of nontraditional activities that banks may consider to help meet their responsibilities are described, includ-

ing debt investments, equity investments, and other services and activities.

Conclusion

Review of CRA in a bank such as this, which has a niche market in a specialty area, must be carefully analyzed to ensure that all aspects of the bank's CRA performance are evaluated properly. There are two objectives that must be achieved through a bank's CRA program. The first is that results must be apparent, and the second is that these results must come from the bank's delineated community. The bank must find products that both meet the credit needs of low- and moderate-income individuals and fit into the servicing abilities of the bank's staff.

It is reasonable that this bank would not have a significant amount of direct lending to low- and moderate-income individuals, because the bank's niche services (private banking) are traditionally targeted at high-income individuals. This bank should not be expected to develop expertise that does not pertain to the needs of 80 percent of its business. However, the institution must find other ways to meet its obligations under the CRA. This bank had attempted to do this through the purchase of SBA pools and developing relationships with groups, leading to the financing of projects that will help meet the needs of the individuals within the bank's delineated community. Although the bank had instituted several programs that should improve its performance under CRA, sufficient time had not transpired for the results of these programs to be evident. Based on the information included in the bank's appeal package, coupled with a review of the examination workpapers, and discussions with an examiner experienced in CRA activities in niche market banks, it was concluded that the appropriate rating as of the date of the PE remains "Needs to Improve." It was also evident that since the writing of the PE, some of the bank's efforts were resulting in a tangible benefit to the bank's delineated community. For this reason, the scheduling of the bank's next CRA review was moved up approximately three months.

Postscript: Examiners assigned to the district where the bank is located recently completed a CRA examination of the bank, which resulted in a rating of "Satisfactory Record of Meeting Community Credit Needs."

Case 6: Appeal of Decision Concerning Retroactive Application of Accounting Requirements

Background

A bank appealed a decision issued by the Office of the Chief Accountant in conjunction with the bank's supervisory office concerning retroactive application of two accounting and record-keeping requirements for mortgage banking activities. First, the bank seeks to avoid application of an initial inherent rate of return as the discount rate for existing purchased servicing. Second, it is attempting to avert exclusion of cash flows from existing originated mortgages in the impairment analysis of purchased mortgage servicing rights (PMSR).

On the first issue (discount rate), the bank does not want to comply with OCC and GAAP guidelines on a retroactive basis because of the extreme amount of effort involved in calculating the initial inherent rates for servicing purchased in previous years. The bank states that in mid-1992, with the concurrence of the local examiners, it began using a pricing model (run monthly for each product line) to ensure that prices paid for servicing did not exceed the present value limitation established by SFAS No. 65. At the end of each quarter, the cash flow stream for each pool is discounted using an effective long-term rate based on an adjusted Treasury rate. With this control in place, the bank capitalizes PMSR for each mortgage at the amount paid. As the pricing model is only run on a product-level basis, the bank does not have a record of the initial rates of return for the PMSR of each mortgage. Further, the prepayment and revenue assumptions that would have been used for products purchased prior to use of the pricing model are not documented.

Management requests that the bank be allowed to implement this change on a prospective basis with the initial inherent rate used as the discount rate for all servicing rights purchased after March 31, 1994. For previously purchased servicing, the bank would utilize an internally developed discount rate matrix that indicates an "add-on spread" for converting the Treasury rate to an appropriate discount. The spreads were determined based upon information obtained from the bank's external auditors and other independent sources.

On the second issue (separation of cash flows), the bank claims it would require many hours of data entry and programming to re-work their model to a loan-level methodology to exclude the cash flows from originated mortgages. Certain loan-level data has not been maintained since late 1992. While management believes that the amount of these cash flows would not result in a material difference in amortization and impairment, the bank has been unable to substantiate the exact amount of the impact to the examiners without reprogramming the model. Further, the bank notes that the Financial Accounting Standards Board (FASB) is reconsidering the accounting treatment presented by SFAS No. 65 specifically in regards to the treatment of originated servicing rights. According to the bank, it

appears certain that by the end of 1994, GAAP will make no distinction between servicing rights from an originated mortgage and a purchased mortgage. Therefore, the bank requests that the exclusion of cash flows from originated mortgages be implemented on a prospective basis only, with cash flows from retail products excluded for all pools sold after March 31, 1994.

Discussion

The instructions to the *Consolidated Report of Condition and Income* (call report) state that PMSR "shall be carried at a book value that does not exceed the discounted amount of estimated future net cash flows. Management of the institution shall review the carrying value at least quarterly, adequately document this review, and adjust the book value as necessary...The discount rate used for this book value calculation shall not be less than the original discount rate inherent in the intangible asset at the time of its acquisition, based upon the estimated future net cash flows and price paid at the time of purchase."

Further, the call report instructions state the following: "In order for a bank to report such mortgage servicing rights as an intangible asset the rights must: (1) represent the bank's obligation to service mortgage loans owned by others, (2) have been purchased or otherwise acquired in a bona fide transaction, and (3) provide for the receipt of future servicing revenue which is expected to exceed the anticipated costs of providing the servicing...The right to service a bank's own loans (whether originated directly or purchased) shall *not* be reported as an asset."

Conclusion

1) The bank's proposal is acceptable. Using an estimated discount rate based upon a realistic spread over Treasury securities at the time of purchase is reasonable, given the lack of bank records supporting the true inherent discount rate. The matrix provided by bank management is reasonable, and may be used for establishing discount rates for existing PMSR. The assigned discount rates should remain constant for the remainder of these assets' lives. For all servicing rights purchased in the future, the bank should use a discount rate not less than the original discount rate inherent in the intangible asset at the time of its acquisition. This is consistent with the way OCC has treated other banks in the same situation.

2) Bank management needs to address this issue to ensure that cash flows from originated mortgages are not included in the valuation and impairment testing process for PMSR. The latter are a separate asset and must not be commingled with retail production cash flows. Neither GAAP nor RAP permit unrelated revenue sources to support the value of PMSR.

As the bank notes, FASB is considering a revision to SFAS No. 65 to make the accounting for originated mortgage servicing rights more like that for PMSR. The revision would provide, in certain circumstances, for servicing from originated mortgages to be capitalized. However, the initiative is only a pre-exposure draft at this time. Further, its provisions would only be applied prospectively, with retroactive application prohibited.

The Ombudsman's Office believes a reasonable alternative, based upon available bank information, is the utilization of the original mortgage pool percentage as a means of determining the portion of mortgage pools with retail originations. While the current mortgage pool percentages may be somewhat different from the original percentages due to prepayments, defaults, etc., this alternative provides a reasonable estimation preferrable to the bank's present approach.

Case 7: Appeal of Violations of Regulation Z

Background

A formal appeal was received concerning several violations of Regulation Z that resulted from the implementation of a secured credit card program. These violations included open-end and closed-end credit transactions.

Nine months before a routine examination, a bank entered into a business relationship with a loan broker. The agreement was that the loan broker would solicit credit card applications from individuals and would require these applicants to pledge collateral (either cash or the cash value on a life insurance policy) in favor of the loan broker. In exchange, the loan broker would present the applications to the bank and offer the bank the partial guarantee of the loan broker on the underlying obligations of the customers. The loan broker charged the applicants fees for its services. At the time the bank entered into the relationship with the loan broker, the programs were limited to "cash cards" and "insurance cards." Four months later the insurance card program was no longer offered. At that time, a derivation of the cash cards called "installment loan cards" became available. In addition to offering the above, the bank purchased existing credit card accounts receivables from another bank. The other bank previously had a relationship with this loan broker. The highlights of the agreement are detailed below.

Establishment and Maintenance of Pool

A pool was set up at the bank that would function as follows:

The loan broker agreed to deposit to the pool an amount equal to approximately 50 percent of the approved line for each credit applications accepted by the bank. In addition to the above, funds in a similar pool were transferred from the bank in which the receivables were purchased. If a customer of the loan broker defaulted on his or her obligation to the bank and the default remained uncured for three billing cycles from the date of default, the default in the credit was cured by payment in full from the funds in the pool. The loan broker agreed that at all times at least 30 percent of the dollar amount of the aggregate approved credit card lines would be maintained in the pool.

Loan Broker's Guarantee

A partial guarantee was set up in addition to the pool account. This guarantee functioned as follows:

The partial guarantee covered all amounts due to the bank in connection with the cards of the loan broker customers to the extent such amounts were incurred or charged within four years after the issuance date of the credit card. The guarantee was limited to $1MM after the bank's receipt and application of the pool and the bank's receipt and application of all collateral under a pledge and security agreement of the same date.

Cash Cards

An individual would offer cash collateral in the amount of the credit line desired. In addition, the individual would pay the loan broker a participation fee. In exchange, the loan broker would agree to submit the credit card application to the bank and to support the application with its own partial guarantee which it collateralized with the pool account. The loan broker agreed to return the collateral to the individual upon cancellation of the card and repayment of all indebtedness thereunder.

Insurance Cards

All customers had the following three options for securing their credit cards:

- Provide cash collateral to the loan broker;
- Provide an existing life insurance policy with a sufficient cash surrender value to the loan broker; or
- Purchase life insurance with sufficient cash value through the loan broker and then pledge that insurance to the loan broker.

Once sufficient collateral was pledged to the loan broker, the loan broker would present the application to the bank. If the application was approved the loan broker would extend a partial guarantee on the customer's indebtedness for four years. The loan broker supported the guarantee with the deposit account described above. The pledge of the insurance to the loan broker remained in effect only as long as the credit card remained outstanding. Once the credit card was cancelled the customer would own the insurance policy free of any assignment. The insurance was universal life insurance or whole life insurance, not credit insurance. Neither the bank, the loan broker, nor any loan account was ever listed as a beneficiary on any of these policies. Each insured was at liberty to list his or her own designated beneficiary. The bank had no knowledge of how much insurance each customer purchased. These cards were only offered for four months.

Installment Loan Card

When the bank and the loan broker stopped offering insurance cards, the bank began to offer the installment loan card. This program was a derivation of the cash card program, designed for persons who did not have sufficient cash to meet the loan broker collateral requirements. Under this program, the loan broker would arrange a 24-month installment loan from the bank for the borrower. The borrower would instruct the bank in writing to disburse all of the proceeds to the loan broker. The loan broker would keep one portion of the loan proceeds as its fee. The loan broker would place the remainder of the proceeds in the pool account. In some instances, the loan broker promised to return the portion of the installment loan that it placed in its reserve account, less a fee. In other situations, the loan broker made no such promise.

Once the individual made two installments on the 24-month note (the first payment being taken at the time of the application), the bank would extend a credit card loan to the individual. The loan broker extended its limited guarantee to both the installment loan and the credit card loan.

Recap of Program

These programs ran in tandem with the bank's own pre-existing credit card program; however, the bank offered guaranteed credit cards only to borrowers who applied through the loan broker. The interest rates and fees earned by the bank on its own cards versus those generated by the loan broker were somewhat different.

although the bank did not feel they were significantly different.

Discussion and Conclusion

The examination report listed nine violations of Regulation Z that occurred in connection with the bank's program to issue guaranteed or secured credit cards. Under the program, the loan broker would guarantee borrower's loans with the bank. The bank offered guaranteed credit cards only to borrowers who applied through the loan broker.

The loan broker prepared the credit card applications on behalf of these borrowers and forwarded them to the bank for approval. For its services, the loan broker charged the customer various fees. The loan broker required borrowers to provide one of three forms of collateral as detailed above to get its guarantee.

Based on these facts, which are not disputed by the bank, the supervisory office cited the bank for violations of Regulation Z, including failure to disclose the proper finance charges and annual percentage rates (APRs) for various extensions of credit. The bank has appealed all violations on two general grounds:

(1) The bank did not believe that the loan broker should be treated as a creditor but as a third-party broker, therefore allowing the fees paid to a third-party broker not to be considered finance charges under the Truth in Lending Act (TILA) and Regulation Z.

(2) The bank did not believe the Office of the Comptroller of the Currency (OCC) correctly calculated the amount of the finance charges.

Treatment of Creditors and Fees Paid to Third Parties

TILA and Regulation Z require lenders to disclose the cost of credit to borrowers, including all finance charges associated with the loan. See 15 U.S.C. 1637, 1637a, 1638(a), and 12 CFR 226.6, and 226.18. Regulation Z states:

> The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. It does not include any charge of a type payable in a comparable cash transaction.

The loan broker imposed various fees on borrowers who sought guaranteed credit cards from the bank. The OCC determined the bank was required to disclose those costs as finance charges. The bank contends that these fees were charged by the loan broker for the loan broker's benefit and, therefore, the bank is not required to include the third-party fees in the finance charges for the bank's loans.

The Official Staff Commentary on Regulation Z (226.4(a) Definition, note 3) explains how charges by persons other than the creditor are treated. It states the following:

> *Charges by third parties.* Charges imposed on the consumer by someone other than the creditor for services not required by the creditor are not finance charges, as long as the creditor does not retain the charges. For example:
>
> - A fee charged by a loan broker to a consumer, provided the creditor does not require the use of a broker (even if the creditor knows of the loan broker's involvement or compensates the loan broker); . . .

In contrast, charges imposed on the consumer by someone other than the creditor are finance charges (unless otherwise excluded) if the creditor requires the services of the third party. For example:

> - A fee charged by a loan broker if the consumer cannot obtain the same credit terms from the creditor without using a broker.

The appeal contends that the supervisory office is treating the loan broker as a creditor under Regulation Z by attributing the fees charged by the loan broker to the bank. However, this mischaracterizes the basis for the violations. The OCC is viewing the loan broker as a third party that the bank required customers to use if they wanted, or needed, guaranteed credit cards. Because borrowers could obtain guaranteed credit cards from the bank only by applying through the loan broker, the bank was required to include the loan broker's fees in the finance charges for those extensions of credit.

The appeal also discusses that customers were not required to use the loan broker to obtain credit cards from the bank. The law is clear that a broker's fees need not be included in the finance charge if the borrower can obtain the same credit terms from the lender without using the broker. In this bank's case upon the bank's own admission the loan broker borrowers could not receive the same credit terms directly from the bank. Moreover, the bank required the loan broker customers to obtain the loan broker's guarantee in order to receive a credit card.

Amount of Finance Charges

The loan broker offered to guarantee a customer's credit card debt under the three different programs

described above. It was immaterial to the bank which program a customer used since the loan broker provided the same guarantee and collateral to the bank under each program. However, different costs were associated with each program; consequently, the amount of the finance charges for each loan was affected by how the customer met the bank's requirement that the loan broker guarantee the customer's loan.

The bank argues that certain fees imposed by the loan broker in connection with the insurance card and installment loan card should not be included in the finance charge under Regulation Z. The thrust of the argument is that the bank did not require customers to obtain insurance or take out an installment loan to obtain a guaranteed credit card because customers had the option of meeting the loan broker's collateral requirements by providing cash collateral. Although this is true, it is the purpose of Regulation Z to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him or her and avoid the uninformed use of credit. Regulation Z requires the bank to disclose the finance charge for the particular option chosen by each customer, otherwise the borrower would have no way of comparing the cost of the different finance options, a condition that the Truth in Lending Act intended to remedy.

The bank will be required to reimburse affected customers. Because of the variety of different options that were offered, the appropriate OCC District Office will provide guidance on which charges should be included in the finance charges for each of the various options. The District Office will also review the bank's calculations for accuracy before any reimbursements are made.

Litigation Update

The Litigation Division represents the OCC in court. During the first half of 1994, the courts handed down a number of significant judicial decisions involving the OCC. These decisions concerned the sale of annuities by national banks and the OCC's authority to appoint receivers and conservators for national banks.

Sale of Annuities

In *Variable Annuity Life Insurance Company v. Clarke*, 993 F.2d 1295 (5th Cir. 1993), *reh'g denied sub nom. Variable Annuity Life Insurance Co. v. Ludwig*, No. 92-2010 (5th Cir. Jan. 13, 1994), the U.S. Supreme Court granted and consolidated the petitions of the OCC and NationsBank for writs of certiorari. Therefore, the Supreme Court will review the opinion of the U.S. Court of Appeals for the Fifth Circuit, which holds that: (1) 12 U.S.C. 92, which enables national banks located in small towns to act as insurance agents, prohibits all other kind of insurance sales as agent by national banks, even those admittedly part of, or incidental to, banking, and (2) annuities, both fixed and variable, are "insurance" within the meaning of that statute and thus cannot be brokered by national banks not located in small towns. The case will be heard once the Court returns for its October term.

In *In re New York State Ass'n of Life Underwriters v. NYS Banking Dept.*, 632 N.E.2d 876 (N.Y. 1994), New York State's highest court held that: (1) New York State banking law's "incidental powers" clause authorizes state-chartered banks to purchase and sell annuities; and (2) annuities are investments, not insurance. The language in 12 U.S.C. 24(Seventh) came from New York's incidental powers clause. The Department of Justice filed an amicus brief on behalf of the OCC in this case.

Appointment of Receivers and Conservators

In *Golden Pacific Bancorp v. United States*, Fed. Cir. No. 92-5141 (2/8/94), a panel from the U.S. Court of Appeals for the Federal Circuit unanimously affirmed the U.S. Court of Federal Claims, holding that the OCC's placement of Golden Pacific National Bank into receivership in 1985 did not constitute a compensable taking. The bank had issued so-called "yellow" CDs, which the OCC determined during an investigation were deposits not backed up by adequate assets and that the bank was book insolvent. Rumors of the OCC's investigation caused a run on the bank. OCC then closed the bank on both book and liquidity insolvency grounds. Afterwards, the bank's owners challenged the closing pursuant to the Administrative Procedure Act, the Federal Tort Claims Act, and the Fifth Amendment. The district court granted the OCC summary judgment and the District of Columbia Circuit affirmed. Then plaintiffs pursued their takings claim in the Court of Federal Claims and the Federal Circuit. After the plaintiffs' rehearing petition was denied, they filed a petition for review with the U.S. Supreme Court.

In *First National Bank & Trust of Wibaux v. OCC*, Cause No. CV 92-121-BLG-JDS, the U.S. District Court for the District of Montana denied plaintiffs' motion to alter or amend its grant of summary judgment to the OCC. The court granted the summary judgment motion last year, finding that, based on the voluminous record before it, the OCC's decision to place the First National Bank & Trust of Wibaux into conservatorship was lawful and had a rational basis. The case is now on appeal before the U.S. Court of Appeals for the Ninth Circuit.

Other Matters in the Litigation Division

In addition to representing the OCC in court, the Litigation Division also drafts administrative decisions for the Comptroller's signature and represents the OCC in administrative litigation before the Equal Employment Opportunity Commission, the Merit Systems Protection Board, and the General Services Board of Contract Appeals.

Speeches and Congressional Testimony

Statement of Eugene A. Ludwig, Comptroller of the Currency, before the House Committee on Banking, Finance, and Urban Affairs, on bank involvement with hedge funds, Washington, DC, April 13, 1994

Mr. Chairman and members of the committee, thank you for the opportunity to appear today to discuss the safety and soundness issues associated with bank involvement with hedge funds. As supervisor of national banks, the Office of the Comptroller of the Currency (OCC) believes that the recent volatility of financial markets is an important issue. The OCC is devoting resources to ensuring that banks adequately monitor and control the risks associated with their exposure to hedge funds, their own trading activities (including the proprietary trading operations of multinational banks), and other activities that pose similar risks. We are committed to continually improving our understanding of bank exposure to, and transactions with, hedge funds.

As the following responses to the questions in your invitation letter indicate, only eight national banks, and nine national banking companies, have some form of exposure to hedge funds. The risks associated with those exposures are, at present, relatively small; our examiners report that those banks are adequately controlling those risks, primarily through the use of margin and collateralization arrangements. Partly in response to recent market developments, however, we have recently increased our scrutiny of national bank activities related to hedge funds. We will continue to follow those activities closely, and we are prepared to reassess our approach to supervision of such activities if circumstances should warrant.

Q1 General Information

How does the OCC define hedge funds? Please provide a list of hedge funds with significant exposure to banks including their balance sheet and income statement data and assets under management. Is there any available measure of the degree of leverage that hedge funds employ? In what markets do hedge funds operate?

The term hedge fund is not defined in the federal banking or securities laws, and it has no precise legal definition. Generally, however, the term is used to describe private investment vehicles that tend to be organized as private limited partnerships and are exempt from regulation under the Investment Company Act. As such, they are limited to 100 or fewer investors. Fund managers, who often invest their own money in the fund, generally offer participation through a private-placement memorandum. Hedge funds usually require large minimum investments (e.g., ranging from approximately $250,000 to $5 million) and charge an annual fee (e.g., 1 percent) as well as a percentage (e.g., 20 percent) of annual profits. Redemptions and transferability of partnership interests are limited, so hedge funds are relatively illiquid investment vehicles.

Hedge funds may take both short and long positions, use cash instruments as well as over-the-counter (OTC) and exchange-traded derivatives, and invest in different financial instruments and financial markets around the world. The general consensus is that hedge funds tend to be highly leveraged; however, as is the case with other highly leveraged entities, the degree of leverage is difficult to measure because they trade actively and use a wide variety of off-balance-sheet instruments. Anecdotal evidence suggests that there may be over 500 hedge funds, although an exact number would be difficult to obtain because the funds are not registered.

The OCC's supervision of national banks focuses on the risks to which banks are exposed. National banks do not appear to be directly exposed to significant risks as a result of their activities involving hedge funds. However, the six national banks that are derivatives dealers, and some major state banks, engage in activities similar to those of hedge funds, and those activities may present similar risks. In particular, the proprietary trading units of some of these national banks actively trade cash and derivatives instruments to take positions and to establish a risk position for the bank. The volume of trading conducted in those units of national banks is a relatively small portion of the bank's overall derivatives activities. Nonetheless, we supervise such trading operations closely to ensure that national banks operating them are adequately controlling the associated risks.

In each of the six dealer banks, a full-time examiner staff monitors trading and risk management activities. In addition, we have been active in developing policies to ensure that banks conduct their trading operations in a safe and sound manner. On October 27, 1993, we issued a Banking Circular on risk management of financial derivatives (BC 277), which requires banks to properly measure and monitor the individual and aggregate risks associated with their derivatives portfolios, and to set and follow appropriate risk limits. As BC 277 states, we expect national banks to apply its guidelines not only to their derivatives activities, but

to risk management generally, including their non-derivatives trading activities, to the extent possible.

We are also developing supplemental examiner guidance to accompany BC 277, which will include detailed procedures for the supervision and examination of a bank's derivatives activity. Our examiners are currently field testing the guidance, and we expect to issue a final version within the next few months.

Q2 Bank/Hedge Fund Relationship

What is total bank exposure to hedge funds? Please include totals for extensions of credit, guarantees, derivatives exposures, etc. What is the total bank credit risk exposure to hedge funds?

Please list all the banking services provided to hedge funds and the revenue derived from those services. Are any banks investors in hedge funds? Do any banks act as investment advisors to hedge funds?

We are not aware of an information source that would enable us to describe total bank exposure to hedge funds; therefore, we are only able to provide data for those banks for which we have supervisory responsibility.

Eight national banks have some form of exposure to hedge funds, providing one or more of the banking services listed below. OCC examiners surveyed each of the eight banks and found that, as of December 31, 1993 and March 31, 1994, the largest area of exposure of national banks to hedge funds was through direct lending. That lending was largely secured.

Those eight banks provide the following banking services to their hedge fund customers:

- Direct lending, secured and unsecured.
- Lines of credit for foreign exchange, derivatives, fixed income securities, precious metals, and emerging markets trading.
- Lines of credit for government securities repurchase agreements.
- Standby letters of credit.
- Payment services for foreign exchange trading.
- Custodial services.
- Securities clearance.
- Brokerage services for execution and clearing of trades.
- Cash management services.

However, no bank provides every service. Our examiners also found that, as of year-end 1993, aggregate direct lending exposure to hedge funds in those eight banks and their holding companies was $669 million. The positive replacement cost (or credit risk) of the trading exposure to hedge funds in those eight banks and their holding companies was $101 million. The majority of these transactions were partially or fully collateralized. Collateral covered 234 percent of aggregate direct loan exposure and 38 percent of trading exposure.

Excluding the exposure of bank affiliates, the credit exposure of the eight national banks was no more than $526 million. This represents no more than .03 percent of national bank assets.

These data indicate that the credit exposure of these eight national banking companies is small relative to their exposures to other borrowers, totalling .09 percent of these companies' assets and .91 percent of their capital. Moreover, these exposures are collateralized to a large extent. We believe, therefore, that the risks associated with national bank involvement with hedge funds are relatively small, and that banks are adequately controlling those risks.

As of March 31, 1994, the aggregate credit exposure to hedge funds of these eight banking companies (through direct lending and trading lines of credit) had increased 34 percent over year-end 1993 to $1.04 billion. Of that aggregate exposure, direct lending exposure was $880 million, and the positive replacement cost of their trading exposure was $151 million. Collateral covered 159 percent of direct lending exposure and 66 percent of trading exposure.

Our examiners have also found that the parent holding company of one of the eight banks mentioned above, and the parent company of an additional national bank, have equity investments in hedge funds. One of those hedge funds is sponsored by a state-chartered bank. Their investments totaled $45 million as of December 31, 1993, falling to $30 million by March 31, 1994. The investments are quite small relative to the banking companies' other investments, their capital, and their annual earnings. No national banks act as investment advisors to hedge funds.

The data that would enable us to provide the committee with consistent information about the revenues asso-

ciated with the services national banks provide to hedge funds are not available.

Q3 OCC Monitoring of Hedge Funds

Please describe the means used by the OCC to evaluate the degree of bank credit risk exposure to hedge funds. Does the OCC require banks to report any information on their exposure to hedge funds? Has the OCC performed any studies on bank exposure to hedge funds? Does the OCC have any plans to require banks to report on hedge fund exposure?

OCC examiners evaluate the degree of bank credit risk exposure to hedge funds during periodic examinations, as part of their oversight of all bank activities involving credit risk. As the response to Question 2 describes, total bank credit risk exposure to hedge funds, which occurs as the result of secured and unsecured direct lending, trading relationships, and other services banks provide to hedge funds, is small relative to their exposures to other borrowers, and relative to their earnings and capital. To date, we have not found it necessary to impose formal reporting requirements relating specifically to hedge funds. If, at a later date, we find our current procedures to be inadequate, however, we will take steps to get the information we need. Those steps could include adopting formal reporting requirements.

Largely as a result of recent market developments that have been unfavorable to the financial position of many hedge funds that have relationships with national banks, we have increased in recent months the attention we are paying to bank hedge fund activity. In February of this year, OCC examiners began to collect additional information regarding bank credit exposure to hedge funds. We summarize the data collected by our examiners in the responses to Questions 2 and 4.

Since hedge funds are not rated by the independent credit agencies, based on what information do banks lend to hedge funds? Do hedge funds provide adequate data for banks to make credit decisions? Does the fact that a hedge fund is also usually a purchaser of derivatives sway the banks' credit decisions in any way?

Our examiners have found that banks evaluate the credit risk associated with a prospective transaction with a hedge fund (or with any other borrower that does not regularly disclose financial data to the public or to the rating agencies) by obtaining the specific information that they need to make an informed credit decision directly from the borrower.

Banks rely heavily on specific knowledge about the fund manager, the investment record of the fund, and the fund's investment strategy. Although banks require regular submission of financial statements from hedge funds with which they transact business, they rely less heavily on such statements because hedge funds tend to engage in a large volume of trading and off-balance-sheet activity. Banks also use information they obtain through any other customer relationships they may have had with the counterparty.

As described in the response to Question 2, national banks lending to hedge funds secure a large portion of the associated credit exposure by requiring the funds to post collateral. The banks place great reliance on the quality and liquidity of the collateral, and if appropriate, they require collateral margins of over 100 percent. In addition, they ensure control over the collateral.

After the bank has made the decision to extend credit, it communicates with the counterparty as frequently as is necessary to monitor adequately its credit risk position. Because of the importance of collateral in lending relationships with hedge funds, the banks monitor the value of collateral often, usually on a daily basis.

To ensure safe and sound management of banks' credit risk exposure, OCC policy requires that a national bank's credit function be separate and independent from its derivatives trading function. Specifically, OCC's BC 277 requires bank management to ensure that credit authorizations for derivatives customers and the bank's risk monitoring are provided by personnel independent of the trading unit. Hence, a credit unit that is independent of the bank's trading unit approves and monitors the bank's credit exposure.

Q4 Hedge Funds as Bank Derivatives Customers

In dollar and quantity terms, what percentage of bank OTC derivatives contracts are purchased by hedge funds? What percentage of exchange traded derivatives contracts are purchased by hedge funds?

As we note in our December 3, 1993 response to the committee's October 5, 1993 letter on bank derivatives activities, a few national banks have established or acquired operating subsidiaries that are Securities and Exchange Commission (SEC)-registered broker-dealers or Commodities Futures Trading Commission (CFTC)-registered futures commission merchants (FCMs), to engage primarily in exchange-related derivatives activities. As of December 31, 1993, 9 percent of transactions cleared by one national bank's FCM were with hedge funds, and less than 1 percent of transactions that were cleared by another national bank's FCM were with hedge funds.

Our examiners queried the eight national banks that have trading relationships with hedge funds and found

that less than 1 percent of their total OTC derivatives transactions outside FCMs are with hedge funds.

Data that would enable us to further answer the committee's questions are not available to the OCC.

Are there any restrictions or prohibitions on the sharing of information on hedge fund purchases of derivative products between bank derivative operations and bank trading account operations?

Many national banks that engage in OTC derivatives transactions as dealers with their customers also engage in a relatively small volume of proprietary trading. The OCC has not required national banks to erect any legal or physical barrier between the two functions, or between customer transactions and any other trading activity of the bank in foreign exchange, precious metals, or government securities.

Bank dealers use information they gain from observing customer transaction flows to develop views on major market movements. Such information is important to dealers and may allow them to operate more effectively.

However, a bank's derivatives customers may not be any more prescient than the bank regarding future market movements, so any information gleaned from customer transactions may be of limited use to the bank. Furthermore, each customer's circumstances are unique and may not be driven by the customer's opinion about general market movements. They could, for example, result from the customer's desire to hedge other positions. Thus, a customer's purchase of a particular product or set of products would not necessarily indicate the customer's opinion about market movements. In this case, following the customer's lead would not necessarily serve the bank's proprietary trading objectives.

The OCC believes that national banks can safely carry out both customer and trading functions in the same department, provided they have appropriate systems and controls in place. BC 277 emphasizes that dealer banks should have or implement proper systems and controls to manage both functions in a safe and sound manner.

In addition, the above-mentioned national bank operating subsidiaries that are SEC-registered broker-dealers or CFTC-registered FCMs are subject to SEC and CFTC rules designed to protect against conflicts of interest between transactions executed on behalf of the subsidiaries and their affiliated parties (included affiliated bank) on the one hand, and transactions executed on behalf of their customers on the other hand. The restrictions are based on the agent/fiduciary obligations of broker-dealers and FCMs. (When banks trade derivatives, precious metals, or foreign exchange contracts with hedge funds, they do so as principals.)

Q5 Hedge Funds and Systemic Risk

What risks do hedge funds pose to the safety and soundness of the banking system? For example, how would the failure of a large hedge fund and the ensuing default on derivatives contracts affect banks and the derivatives market?

As the answer to Question 2 indicates, national bank exposure to hedge funds is relatively small, for the most part collateralized, and subject to credit risk controls that would apply in any extension of credit to any highly leveraged borrower. Therefore, the national bank exposure to hedge funds that we describe does not pose particular safety and soundness risks either to any individual bank or to the banking system.

Certainly, however, financial regulators have reason to be concerned about the potential systemic impact of hedge fund activity. The rapid growth in volume and complexity of derivative instruments, and the accompanying rapid improvements in technology and telecommunications, has increased the rate at which shocks spread throughout the financial system.

Hedge funds participate in many of the same derivatives activities that banks engage in on behalf of customers and as part of their own risk management. As bank supervisors, the OCC has concerns about the risks associated with the markets in which banks and hedge funds participate, as well as banks' vulnerability to systemic events in those markets.

In particular, we are concerned about the liquidity of some of the markets in which banks and hedge funds participate. Rapid movements in market conditions could lead to simultaneous efforts by many banks and other market participants, including hedge funds, to limit their exposures. In some cases, the markets may not be sufficiently liquid to allow all participants to execute their desired transactions in an orderly fashion. To address this concern, BC 277 requires bank managers to establish effective controls over the liquidity exposure arising from financial derivatives activities. In addition, the circular requires banks to manage their liquidity exposure resulting from financial derivatives activities as an integral part of their day-to-day operations, as well as their contingency and liquidity planning processes.

In addition, as BC 277 makes clear, the OCC believes that the best defense against systemic risk is for each bank to implement effective risk managment systems

that ultimately include limits and controls on interconnection risk and the ability to monitor the exposure resulting from the covariance between one or more risk factors. As stated above, we are preparing supplemental guidance for examiners, which we plan to issue within the next several months, that emphasizes the need for all banks to have risk management systems in place that are sufficient to measure, analyze, and control each of the risks arising from derivatives activities, and to have sufficient capital to absorb potential losses from those risks.

Does the OCC contemplate taking any action that would curb the aggressive trading strategies of hedge funds? Does the OCC have any contingency plans should a large hedge fund fail?

Because none of the banks we supervise have created hedge funds, the specific trading strategies of hedge funds are outside of OCC's regulatory jurisdiction. Instead, OCC supervision aims to ensure that national banks have proper policies and procedures in place to manage adequately their activities, including activities involving hedge funds. We require national banks to account appropriately for the credit, market, liquidity, operational, or other risks that might accompany their associations with hedge funds, and to plan for whatever contingencies might arise in connection with those activities.

Q6 Adequate Netting Arrangements with Tax-Haven Countries

For various reasons, some hedge funds are chartered in tax-haven countries, and these hedge funds purchase derivatives from banks. Is the OCC concerned over the adequacy of netting arrangements with tax-haven countries?

The OCC does have supervisory concerns regarding the adequacy of national bank netting arrangements, including such arrangements with counterparties who are incorporated or otherwise organized under the laws of certain countries, including tax-haven countries. However, as further discussed below, the OCC does not allow a bank to net transactions or contract values for credit risk monitoring purposes or for capital adequacy purposes unless a particular netting arrangement is enforceable.

OCC's BC 277 states that, in order to reduce counterparty credit exposure, a national bank should use master close-out netting agreements with its counterparties to the broadest extent legally enforceable, in circumstances that include any possible insolvency proceedings of such counterparties. As BC 277 notes, the enforceability of bilateral close-out netting arrangements for various derivatives transactions in the insolvency proceedings of U.S. counterparties is almost certain. The advantages of such netting arrangements include a reduction in credit and liquidity exposures, the potential to do more business with existing counterparties within existing credit lines, and a reduced need for collateral to support counterparty obligations. National banks, therefore, can gain substantial potential benefits by documenting their relationships in master agreements that contain close-out netting provisions, and the absence of clear rules permitting netting increases the cost of engaging in derivatives transactions.

However, as BC 277 states, the enforceability of netting provisions against many foreign counterparties, or U.S. branches or offices of some foreign counterparties, is less certain. Where national banks enter into netting arrangements with such counterparties, we require them to obtain an opinion of counsel that any such arrangements would be valid in the event of default and/or bankruptcy before incorporating such arrangements into their calculations of credit and liquidity exposure, and before accounting for financial derivatives transactions with such counterparties on a net basis.

In addition, the only form of netting that is currently permitted by the risk-based capital standards applying to national banks is netting by novation, a restrictive form of netting that occurs when the existing contractual obligation is extinguished by the subsequent new obligations. The Basle Committee has proposed to recognize legally enforceable bilateral netting arrangements when computing a bank's counterparty credit risk exposure in derivatives. The OCC, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision are preparing a proposal to amend their risk-based capital standards to recognize the risk-reducing benefits of such netting arrangements. However, the proposal will require banks to obtain opinions of counsel regarding the legal enforceability of any netting arrangements used to compute counterparty credit risk exposure.

The agencies expect to issue the proposal shortly, with a comment period of 45 days. The OCC believes that this proposal, by encouraging the use of enforceable bilateral netting arrangements, will reduce the level of settlement risk, and therefore the systemic risk, in derivatives markets.

Conclusion

At present, only eight national banks have risk exposures to hedge funds; their exposures are relatively small and adequately controlled. The OCC will continue

to monitor those exposures and other bank activities that pose similar risks. In particular, we will pay attention to bank controls over their liquidity exposure from such activities. We will continue to study the safety and soundness issues related to bank involvement in hedge funds, and, if circumstances warrant, we will revise our regulatory or supervisory approach to national bank associations with hedge funds.

Statement of Eugene A. Ludwig, Comptroller of the Currency, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, on a functional approach to securities regulation, Washington, DC, April 14, 1994

Mr. Chairman and members of the subcommittee, you have asked me here today to discuss the functional regulation of banks and thrifts (depositories) and of securities firms. More particularly, you asked that I include in my discussion some commentary on HR 3447, a bill that strives to achieve functional regulation by compelling depositories to place most of their securities activities[1] in separately incorporated subsidiaries or other affiliates that would be regulated by the SEC and related private-sector supervisors. These issues lie at the very heart of any effort to reform our financial system and the way we supervise it, and I applaud your initiative to focus on them at this time.

We all agree that we must reform the system. Depositories and securities firms do not compete with one another on a level playing field, largely to the detriment of consumers. A hybrid of laws and federal agencies populates a financial-services landscape that demands a comprehensive overhaul. This overhaul should address the important initiatives offered by HR 3447; the products and services appropriate for depositories and securities firms; and the laws, regulations, and federal supervisors to which financial services firms should be subject. The solutions to supervisory problems offered by HR 3447 are too important to be discussed outside this larger context.

Today, Mr. Chairman, I will offer some initial thinking on functional regulation and the context within which we might discuss it. In brief, we should consider looking at functional regulation as one approach to achieving a level playing field upon which depositories and securities firms can compete fairly. In developing a truly level playing field, we should consider applying depository laws to securities firms, as well as applying securities laws to depository institutions. In developing a truly level playing field, we should consider alternatives to functional regulation, such as "entity regulation," a concept I will discuss in greater detail later in this statement. It is within this context that I will also offer some early thoughts on the possible impact of HR 3447 on depositories.

[1]A description of the legal authority underpinning depository securities activities and the laws and regulations to which those activities are subject appears in my written testimony before the House Energy and Commerce Committee dated March 3, 1994. I have appended that section of the statement to this testimony as an addendum.

Let us look first at this idea of a level playing field.

A Level Playing Field

Two ideals define the goal of a level playing field: first, one set of rules should govern competition between depositories and securities firms in any product or service market in which they compete; and second, the appropriate enforcement agencies should enforce those rules equally. For example, one set of rules should apply to the conduct of a particular securities activity; one set of rules should apply to the conduct of a particular depository activity; and each set of rules should apply equally to all who conduct those activities. Those ideals appeal to all of us for they are rooted in the principle of fairness. As a matter of principle, fairness is a goal worth pursuing in its own right. Moreover, we should seek fairness between depositories and securities firms for it enhances competition to the benefit of consumers.

The principle of fairness means more than subjecting depositories to all the securities laws. It also means that we consider having the appropriate depository laws apply to securities firms. For example, securities firms offer cash-management accounts subject to third-party checks that are not subject to deposit reserve requirements. I have more to say on this point later in this statement.

Creating common rules for depositories and securities firms is but half the struggle in our effort to build a level playing field. We must also decide on a framework for enforcing those rules. Here we are faced with a particularly difficult choice because we are not beginning with a clean slate. Depositories and securities firms have their own separate supervisory frameworks, with each framework headed by its own group of supervisors. We tend to think of these frameworks as governing two, broad functions—depository functions and securities functions. We also tend to think of the two sets of supervisors as having expertise in their respective functional areas.

However, these two sets of supervisors also have "institution" or "entity" expertise. They know all about every facet of the operations of the entities they supervise and how all those operations come together and affect the financial condition and prospects of those entities.

Within the context of those two areas of expertise, we can envision two approaches to achieving the level playing field. One approach leverages the "functional" expertise of the two sets of federal supervisors. Under this approach, which we call functional regulation, only the SEC and other securities supervisors such as the National Association of Securities Dealers (NASD) would enforce compliance by depositories and securities firms with all the securities laws. Depository supervisors would enforce compliance with all the "depository laws."

A second approach leverages the institutional or "entity" expertise of federal supervisors. Under this approach, which we can call "entity regulation," the SEC would enforce compliance by securities firms with both the securities laws and the applicable depository laws. At the same time, the federal depository agencies would enforce compliance by depositories with all the securities laws and the depository laws. Regulation by entity would yield a level playing field because both the SEC and the federal depository agencies would be enforcing the applicable laws.

Both functional regulation and entity regulation have the potential for creating a level playing field, but each also has its pitfalls. Functional regulation risks missing the myriad of complex interactions among the parts of a diversified financial services institution and requires regulators unfamiliar with the way such firms work to enforce specific statutes. Entity regulation, on the other hand, requires regulators to learn and enforce new laws. We can understand these advantages and disadvantages more clearly with the benefit of a brief look at the broad mandate Congress has given to the federal supervisors of banks and thrifts.

The Broad Mandate of Depository Supervisors

In assessing functional regulation and entity regulation, we cannot lose sight of the fact that the mandate of those who supervise depository institutions includes both protecting the solvency of banks and thrifts and protecting bank customers and investors.

Congress began developing that mandate over 130 years ago. In 1863, it established the national banking system. Since then, Congress has taken numerous steps, most recently with the passage of FDICIA, to build an extensive framework for the governmental supervision of depositories. A good part of this framework seeks to minimize the risk of depositories becoming insolvent. That goal recognizes the unique role depositories play in our economic system—the simultaneous provision of an efficient payments system and of credit to households and business firms who may have precious few other sources of funds at reasonable cost. Failure of depositories in large numbers, as occurred in the early 1930s, threatens both the payments system and the availability of credit. Our experiences with banks and thrifts in the 1980s serves to remind us of just how closely failure and credit availability are linked.

To meet their safety and soundness responsibilities, depository supervisors know the necessity of examining all the activities in which depositories are engaged. The activities we must assess are not restricted to those related directly or indirectly to such traditional operations as loan underwriting. For purposes of safety and soundness, we must also look at other areas, such as the securities services depositories offer to their customers and related investor protections.

The link between the investor-protection aspects of securities activities and depository safety and soundness is straightforward. For example, when depositories raise funds with issues of debt or stock, we ensure that investors are fully informed about the financial standing of the depository. Ensuring appropriate disclosure protects the depository against the risk that later on shareholders or bondholders might raise substantive legal questions that could threaten bank capital. Disclosure also helps to promote investor confidence in bank securities generally, to the ultimate benefit of banks, thrifts, and the deposit insurance funds.

Depository supervisors are uniquely equipped to ensure complete disclosure, because they have access to applicable examination, enforcement, and other confidential information bearing upon the financial condition and future prospects of the issuer. Depository supervisors are thus in the best position to require appropriate revisions, if disclosures are incomplete or otherwise misleading.

Depository treatment of their other securities customers must be similarly forthcoming. If that treatment does not comply with law or regulation, the prospect of legal redress by harmed parties similarly threatens depository capital. Here, the depository supervisor is responsible for the fair treatment of customers that is essential to the safe and sound operation of the bank or thrift.

Our concern with, and responsibility for, disclosure and compliance in securities-related matters is not restricted to just matters of safety and soundness. We are also concerned about investor protection. That concern is part of a much larger public-interest responsibility Congress has given to us. Since the late 1960s, Congress has increasingly required that depository supervisors ensure depository compliance with a host

of civil rights and consumer protection laws, covering such matters as fair lending, equal credit opportunity, truth in lending, truth in savings, and community reinvestment. In keeping with this broader responsibility, recent changes in federal securities laws reinforced the supervisory role the federal depository agencies play in the securities activities of banks and thrifts.[2]

It is within the context of this broad, public-interest mandate that any discussion of the two approaches to achieving a level playing field should take place. For purposes of our discussion, let us look first at functional regulation. This is the approach to a level playing field taken by HR 3447.

Functional Regulation

Under functional regulation, the SEC and other securities authorities would ensure depository compliance with the securities laws. HR 3447 would leverage the recognized and considerable expertise of the securities authorities, and it would put enforcement of the securities laws exclusively in the hands of those who have investor protection as their primary mission. Some believe this approach holds out the promise for a more efficient use of government resources and thus taxpayers' dollars. Those are appealing arguments, particularly at this time, when the government is facing very tough budgetary decisions. It is against those anticipated benefits that we must measure the costs of such a system.

The greatest cost, in a pure functional regulation system, would be the substantial difficulty of ensuring comprehensive and integrated risk management of supervised institutions. There would be too great a prospect of regulatory issues falling between the cracks. For example, pure functional regulation would preclude depository supervisors from investigating the securities subsidiaries and affiliates of depositories. Since depository supervisors could not assess compliance by the financial-services entity with investor protection or other securities laws, they would have to rely on reports from the functional regulator. These reports might be too infrequent, insufficiently detailed, or insufficiently comprehensive for purposes guarding the safety and soundness of the depository.

To avoid those costs, we would have to abandon pure functional regulation, and by doing so create other costs. For example, we could permit depository supervisors to examine depository securities subsidiaries and affiliates, resulting in a duplicative layer of federal supervision for banks and thrifts. As we all know, duplicative supervision imposes large operating costs upon the regulated entities, reducing their bottom line and their ability to compete. While the SEC would take over enforcement of investor-protection measures, it would not examine the impact of those activities on the whole institution. That responsibility would still lie with depository supervisors; investor-protection issues and securities activities would continue to affect depository safety and soundness, for which the depository agencies are fully responsible. Thus, the depository agencies and the SEC would still have to examine the same records and interrupt the work of the same people, as they went about meeting their individual responsibilities.

There are only two ways we could avoid duplicative supervision, and each presents its own obstacles. First, depositories could take the initiative. They could try to arrange securities-related record-keeping and employee tasks so that a safety and soundness examination of securities activities did not investigate many of the same records and interrupt the work of many of the same employees as an SEC investor-protection examination. Our experience with evaluating bank procedures and operations tells us that such a segregation of records and personnel would likely be very difficult, if not impossible.

The government could take the initiative to avoid duplication. Here, the federal regulators could seek to organize a single, simultaneous, highly coordinated examination for both safety and soundness and investor protection. The OCC and SEC have conducted joint examinations in the past and are planning more for the future. We are seeking to increase our coordination and efficiency at every turn, but we have some way to go before we become so efficient that we act as one and avoid all duplication.

In addition to increasing operating costs, duplicative supervision causes other problems. The opportunities for creating conflicting priorities among, and conflicting instructions from, federal government agencies grow exponentially. There is also the danger of enterprising managers exploiting the fault lines that duplicative supervision creates by playing one supervisor off against the other.

Some might think that compelling depositories to place their customer securities activities into separately incorporated, separately capitalized subsidiaries or other affiliates reduces the opportunities for duplicative supervision and the associated costs. I am not per-

[2] For example, the 1975 amendments to the Securities Exchange Act of 1934 provide that the depository agencies shall enforce the rules governing depository activity in municipal securities. The depository agencies play a similar role in depository activities with federal government securities under the Government Securities Act of 1985, enforcing regulations promulgated by the Treasury Department.

suaded that it would. Currently, many depositories place much of their securities activities in subsidiaries, which are subject to supervision by the SEC. Because of safety and soundness concerns, bank and thrift supervisors examine those subsidiaries too. Depositories could avoid duplicative supervision of securities activities by (1) keeping records and staff dealing only with safety and soundness issues in the depository; and (2) keeping records and staff dealing only with investor protection in the subsidiary. Depositories have not made that division, most likely because it is impossible.

We should also be mindful of the possibility that a separate subsidiary/affiliate requirement could be particularly intrusive for small, independent banks and thrifts. They typically have a limited securities business and do not necessarily have the financial and other resources needed to create, staff, and maintain separate subsidiaries and their separate boards of directors. Government demands that the current securities activities of depositories be placed in separate corporations could drive small, independent banks and thrifts from the securities activities marketplace, to the detriment of their, generally, local customers.

Entity Regulation

Under the pure entity regulation approach to a level playing field, the same laws would generally apply equally to depositories and to securities firms. Drawing upon their institution-based expertise, depository supervisors would ensure compliance by depositories with the applicable depository and securities laws. By the same token, the SEC would ensure compliance by securities firms with the applicable depository and securities laws.

There is precedent for entity regulation; in some measure it guides the supervision of depository securities activities today. In many circumstances, depository supervisors ensure depository compliance with the securities laws. To be sure, depositories are not subject to exactly the same securities laws as securities firms, and securities firms are not subject to the same laws as banks and thrifts. To achieve a level playing field through entity regulation, we will want to analyze those differences.[3]

[3]There could be circumstances in which applying the same laws equally would reduce fairness, rather than increase it. For example, depositories are subject to different capital requirements, because they face different risks. Requiring equal capital requirements would not accurately reflect the risks of those who invest in depositories and securities firms.

Keeping in mind that, as with functional regulation, pure entity regulation demands the equal application of the law, the advantages of regulation by entity become clear. Entity regulation avoids the adverse impacts of the alternative approach. With entity regulation we can have an integrated approach to the supervision of the financial services firm, without increasing the operating costs of banks and thrifts. We can have a system in which the regulated entities have few opportunities to play one supervisor off against another and "game" the system to their advantage and to the detriment of the public.

At the same time, entity regulation does not compromise protection of the public interest. There are no prospects of depository supervisors or securities supervisors being less diligent or vigilant than one another in the enforcement of the depository laws or the securities laws or otherwise less sensitive to the public interest.

It is against those benefits that we must weigh the costs of entity regulation. Entity regulation does raise the prospect of depositories and securities firms being subject to differing interpretations of the applicable laws. Some might conclude that the possibility of different interpretations will keep us from creating a truly level playing field for depositories and securities firms. That would not necessarily be an insurmountable problem. Through coordination, the agencies can strive to apply all provisions of federal law in exactly the same way.

Regulation Today

Today, depositories and securities firms do not compete on a level playing field; they are not uniformly subject to the same depository laws or the same securities laws. In fact, the securities activities of depositories, their subsidiaries, and affiliates are covered by a hybrid of securities and depository laws that seems to defy an easily understood and clear generalization.[4] This state of affairs is rendered all the more complex by the fact that we do not have functional regulation or entity regulation for the securities activities of depositories. A mixture of the federal depository agencies, the SEC, the NASD, and Municipal Securities Rulemaking Board (MSRB) supervises those activities.

Although we know we do not have a level playing field, it is hard to figure out against whom the field may be tilted. Over the years, Congress has enacted legislation

[4]To a large extent, this hybrid approach reflects that fact that when Congress enacted the securities laws, depositories were already operating within a pervasive regulatory framework.

designed to ensure that depositories are either subject to some of the same laws securities firms must obey or subject to laws that are comparable to the ones securities firms must obey. Depository supervisors have built upon those themes.

Depositories Subject to Comparable Securities Laws

For example, the same laws govern activities by depositories and securities firms in municipal securities, federal government securities, and transfer agent operations. Moreover, the SEC supervises other brokerage activities if depositories conduct them through a subsidiary or other affiliate.[5] Other instances in which the same laws apply to depositories and securities firms include: Section 12 of the Securities Exchange Act of 1934, which governs disclosure requirements for publicly held companies; the anti-fraud provisions of the federal securities laws; and the provisions of the Investment Company Act (ICA) that cover investment advisors. Even though banks are not required to register with the SEC as investment advisors, the provisions of the ICA governing investment advisors apply to banks. These provisions include, in addition to the fraud provisions, the fiduciary duty requirements and the disclosure requirements imposed on all persons who advise mutual funds.

When federal law has carved out exceptions for banks and thrifts, depository supervisors have acted to ensure treatment comparable to that the SEC provides securities firms. For example, the plenary safety and soundness authority granted to the federal banking agencies under 12 U.S.C. 1818 serves as a powerful investor protection tool. Depository supervisors have recently supplemented that tool with the *Interagency Statement on Retail Sales of Nondeposit Investment Products.* It provides investor protections in the sale of such services as mutual funds on a par with those in the *Rules of Fair Practice* promulgated by the NASD.

In addition, the depository agencies have adopted a number of investor-protection regulations to promote comparability. For example, OCC's regulations at 12 CFR 9 (fiduciary powers; collective investment funds) and 12 CFR 12 (record-keeping; confirmation requirements) provide a comparable level of customer protection in brokerage and investment advisory relationships. Moreover, OCC regulation 12 CFR 16 (securities offering disclosure rules) provides that new debt and equity issues of national banks must meet investor-protection standards similar to those provided by the Securities Act of 1933.

Securities Firms Not Subject to Depository Laws

By contrast, securities firms are subject to a less complex array of laws and supervisors, even though the distinction between securities firms and depositories is becoming increasingly blurred. Because of continuing dramatic breakthroughs in telecommunications and related computer technologies, depositories and securities firms compete across an ever-growing array of products and services. Just as depositories are offering securities services, so too are securities firms offering depository services. Securities firms offer check-writing services in the form of cash management accounts, savings instruments in the form of mutual fund shares, consumer-type loans in the form of credit extended to individuals to fund their securities purchases, and even loans to businesses that go beyond so-called "bridge loans."[6] The fact that under some circumstances, securities firms could have access to the Federal Reserve discount window further blurs the distinction between such firms and depositories.

None of those "depository" services of securities firms are subject to depository laws. The transaction accounts offered by securities firms, which are part of the money supply computed by the Federal Reserve are not subject to deposit reserve requirements. More generally, securities firms are not subject to the host of social responsibility laws that Congress has imposed upon depositories, such as CRA, truth in lending, and truth in savings, despite the fact that securities firms are in various lines of business that compete directly with the deposit-taking and lending activities of banks and thrifts.

There may be sound reasons for such exemptions. However, as we discuss and design the best framework for constructing a level playing field, be it functional regulation, entity regulation, or some hybrid, we should identify and re-examine those reasons. If we ignore them, we run the risk of not creating a completely level playing field upon which depositories and securities firms can compete fairly.

Going Forward: Building Upon the Present

Mr. Chairman, and members of this committee, we all agree that we should create a level playing field for depositories and securities firms, although we may disagree on how we should go about achieving that

[5]We understand that the Federal Reserve Board estimates that approximately 85 percent of bank-related brokerage operations occurs in SEC-regulated entities. Our own experience corroborates that statistic

[6]These are loans that investment bankers provide to firms raising capital until the funds from securities sales become available

objective. Along with Chairman Dingell, you, Mr. Chairman, and others have proposed HR 3447, with its emphasis on functional regulation. I have noted some of the costs this bill would impose and suggested that we expand our discussion to include an alternative, one that emphasizes entity regulation. This alternative approach would lever the institutional or entity expertise of federal supervisors and would avoid most of the costs associated with functional regulation.

In creating a level playing field, we are not obliged to depend solely upon functional regulation or solely upon entity regulation. We can use some of each. Here is how we can do that.

Our ultimate objective would be to ensure that depositories and securities firms play by the same rules through interagency coordination that levers on the functional and institutional expertise of the SEC and the federal supervisors of banks and thrifts. Here the OCC will continue its review of the laws that govern national bank securities activities to ensure that they are not inappropriately different from the securities laws. We will also expand cooperative efforts with the SEC.

Within the last several months we have made great strides in that direction. For example, the OCC has invited the SEC to coordinate examinations of banks and operating subsidiaries subject to supervision by both agencies, including conducting joint examinations of banks and operating subsidiaries involved in mutual fund sales. We are continuing our past practice of sharing information and exchanging information on entities subject to the supervision of only one agency, when such information is relevant to the supervisory concerns of the other agency. Depository agencies and the SEC are also working toward coordinating enforcement actions.

Summary

In summary, Mr. Chairman, depositories and securities firms compete with one another today on something other than a level playing field. We should work to remove the current inequities, while doing the best we can to avoid creating new ones. Those initiatives should occur within the context of a larger reform effort that would overhaul all the laws that govern competition in the financial services industry.

Creation of a level playing field demands a comprehensive and cost-effective rulemaking and enforcement framework. We have several options. These include: functional regulation, entity regulation, and combinations of those two. Under functional regulation, the securities supervisors would exclusively enforce compliance with the securities laws by all companies that conduct securities activities, and, by logical extension, depository supervisors would exclusively enforce compliance with the depository laws by all companies that conduct depository activities. Under entity regulation, the supervisor of the core activities of each company would enforce all the rules to which that company is subject. Each approach has its advantages and disadvantages.

HR 3447 provides a shove in the direction of a level playing field, and would build a framework on the basis of functional regulation. Yet, the case for HR 3447 is not clear-cut. It would appear to reap public-sector benefits at the expense of private-sector costs. I am not as confident as others may be that adoption of HR 3447 will avoid duplicative federal regulation. I am also concerned that small depositories, with perhaps limited securities activities, could easily find the separate incorporation requirements of HR 3447 prohibitively expensive. Finally, HR 3447 does not appear to reflect a reconsideration of the exemptions from depository laws that securities firms enjoy.

Because of those reservations, I suggest that we consider an alternative approach. Let us work toward eliminating inappropriate differences between the depository laws and the securities laws as they apply to depositories and securities firms. Let us consider the benefits of utilizing the entity expertise of both depository and securities supervisors in building our rulemaking and enforcement framework and not limit the discussion solely to functional regulation.

Addendum-Legal Authority for National Bank Securities Activities[7]

The authority of national banks to engage in activities related to mutual funds derives from the National Bank Act's grant of authority to engage in activities that are part of or incidental to the business of banking,[8] and from national banks' express powers to provide fiduciary and custodial services and to act as transfer agents.[9] Banks and their affiliates or subsidiaries may provide investment advice to mutual funds and to customers, may broker mutual funds, may advertise and market their services, and may provide a range of administrative and shareholder-related services to mutual funds. Such services may include acting as transfer agent, custodian, and registrar, and providing record-keeping, accounting, and related services.

[7] This material originally appeared in the written statement of Eugene A. Ludwig, Comptroller of the Currency, before the House Committee on Energy and Commerce, March 3, 1994.
[8] 12 U.S.C. 24(7).
[9] 12 U.S.C. 92a; 15 U.S.C. 78q-1.

However, national banks have not been authorized to sponsor or distribute most mutual funds.

Bank Powers. Section 24(Seventh) grants broad powers for banks to engage in the business of banking, including the specific powers recited in the statute[10] and such other incidental powers as are reasonably necessary to perform the business of banking as a whole. The courts have used various tests to determine whether specific banking activities are within the intended scope of Section 24(Seventh), and have found that permissible incidental activities include those that are similar to an express power, relate to an express power, resemble traditional banking functions, or constitute financial activities.[11]

Banks have authority to buy and sell securities for the accounts of customers as part of the business of banking. This authority under the bank powers clause is evidenced in the history of the years prior to the passage of the Glass-Steagall Act and predecessor provisions of the 1927 McFadden Act.[12] While Section 16 of the Glass-Steagall Act placed limitations on certain securities activities of banks, this provision specifically preserved banks' power to broker such securities "solely upon the order, and for the account of, customers, and in no case for its own account."[13] Various court opinions confirm the long-established powers of banks to perform brokerage services.[14] Accordingly, securities brokerage activities are permissible by national bank subsidiaries including the purchase and/or sale, as agent, of shares in mutual funds.[15]

National banks and their subsidiaries have the authority to provide investment advice as part of or incidental to the business of banking.[16] Investment advice is integral to the brokerage and trust powers of banks. Banking entities are permitted to recommend mutual funds to customers and to act as investment advisor to the same mutual funds.[17] In finding that a bank holding company may serve as investment advisor to a mutual fund, the Supreme Court recognized in 1981 that the functions of an investment advisor include management activities.[18]

An integral part of investment advisory and brokerage services is the ability to attract customers by advertising and marketing the services and products available. In 1954, the Supreme Court, in considering a restrictive state law, found that under their incidental powers national banks generally can advertise any service that the bank lawfully offers.[19] In 1986, the District of Columbia Circuit Court recognized, albeit in a different context, that the selling of securities necessarily involves finding and soliciting buyers.[20] The court noted that banks must advertise to let their customers know what services are available. Hence, national banks are permitted to publicize their services relating to mutual funds.[21]

Administrative services related to the provision of investment advice and brokerage services are also incidental to those activities. National banks and their operating subsidiaries are permitted to provide a variety of administrative and shareholder services with respect to the operation of a mutual fund.[22] The Federal Reserve Board recently has approved a nonbanking subsidiary of a bank holding company to provide various administrative and advisory services to mutual

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[10](1) Discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; (2) receiving deposits; (3) buying and selling exchange, coin, and bullion; (4) loaning money on personal security; and (5) obtaining, issuing, and circulating notes.

[11]*See* Letter No. 494 (December 20, 1989), *supra*, at 11-16; *see also M & M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U. S. 956 (1978); *New York State Ass'n of Life Underwriters v. New York State Banking Dept.*, 598 N.Y.S. 2d 824 (N.Y. App. Div., 1993). (The court found that a similar incidental powers clause of New York banking law permitted banks to expand banking services over time consistent with evolving business practices and customers' needs.)

[12]*See* 12 U.S.C. 24(7).

[13]12 U.S.C. 24(7).

[14]*See e.g., SIA v. Bd. of Governors of the FRS*, 468 U. S. 207 (1984) ("*Schwab*"); *SIA v. Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983), *aff'd per curiam*, 758 F.2d 739 (D.C. Cir. 1985), *cert. denied*, 474 U.S. 1054 (1986) (brokerage issue).

[15]*See e.g.*, Interpretive Letter No. 622 (April 9, 1993); Interpretive Letter No. 403 (December 9, 1987).

[16]*See e.g.*, Interpretive Letter No. 622 (April 9, 1993) and Interpretive Letter No. 367 (August 19, 1986); *see also Bd. of Governors of the FRS v. 1C1*, 450 U.S. 46 (1981); S1A V *Bd. of Governors of the FRS*, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988) ("*NatWest*")

[17]Federal Reserve Board Regulation Y, 12 CFR 225.125; *see also Bd. of Governors of the FRS v. ICI*, 450 U.S. 46 (1981); *SIA v. Bd. of Governors of the FRS*, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988) ("*NatWest*"); Interpretive Letter No. 403 (December 9, 1987).

[18]*Bd. of Governors of the FRS v. ICI*, 450 U.S. 46, 55 (1981); *see also* OCC Letter from William B. Glidden (January 14, 1988) (national bank investment advisors manage and supervise the investment and reinvestment of cash, securities or other properties comprising the assets of the mutual funds).

[19]*See Franklin National Bank v. New York*, 347 U.S. 373, 378 (1954).

[20]*SIA v. Bd. of Governors of the FRS*, 807 F.2d 1052, 1062 (D.C. Cir 1986), *cert. denied*, 483 U.S. 1005 (1987) ("*Bankers Trust II*").

[21]*See* Interpretive Letter No. 622 (April 9, 1993) (making lobby materials available on services, placing newspaper advertisements, sending statement stuffers and providing other descriptions of the variety of services available); Glidden Letter (January 14, 1988) (furnishing prospectus or sales literature on funds upon request, having advertisements and brochures listing mutual funds available through the bank and the bank's services); *see also Interagency Statement on Retail Sales of Nondeposit Investment Products* (acknowledges banks advertise and market uninsured investment products to customers and provides for full disclosure).

[22]*See e.g.*, Glidden Letter (January 14, 1988) (providing various administrative services and acting as investment advisor to mutual funds), Interpretive Letter No. 386 (January 19, 1987) (providing recordkeeping, accounting, and other services in connection with 12b-1 and similar plans); Interpretive Letter No. 332 (March 8, 1985) (recordkeeping, order execution functions, and shareholder information)

funds.[23] The Board reasoned that such administrative activities generally are ministerial or clerical in nature and do not impart impermissible "control" or policy-making authority over the mutual fund. As the Board noted, mutual funds are governed by a disinterested board of directors dictated by various independence requirements of the Investment Company Act of 1940, and ultimate control over the funds rests with their boards of directors.

Glass-Steagall. The Glass-Steagall Act imposes limits on banks' involvement in certain securities activities. Section 16 of the Act (12 U.S.C. 24(7)) places limits on national banks underwriting and dealing in securities and stock and generally prohibits national banks from purchasing or selling securities except upon the order and for the account of customers. Section 20 (12 U.S.C. 377) prohibits Federal Reserve member bank affiliation with a company engaged principally in underwriting and other securities activities. Section 21 (12 U.S.C. 378) prohibits organizations that are engaged in underwriting and other securities activities from simultaneously engaging in the business of receiving deposits. Section 32 (12 U.S.C. 78), prohibits officer, director, or employee interlocks between member banks and companies that are primarily engaged in the securities activities listed in Section 20.

The courts have affirmed that activities that are part of, or incidental to, the business of banking are not prohibited by the Glass-Steagall Act.[24] The mutual fund activities in which national banks and their operating subsidiaries engage do not involve underwriting and dealing, so they are not prohibited by Section 16. Underwriting and dealing typically refer to a banking entity's purchase of shares for its own account, thereby incurring a principal risk. National banks generally may not engage in distribution or sponsorship of mutual funds and typically employ independent distributors to assume these functions. Activities permitted by Section 16 are not prohibited by Section 21. Mutual funds do not take deposits; while a bank and its subsidiary may receive deposits, they are not engaged in issuing, underwriting, or distributing securities. A bank's sale of mutual funds as agent does not constitute Glass-Steagall distribution, even if the bank also acts as the advisor and/or administrator to the funds.[26]

Section 20 also does not prohibit national banks from engaging in many mutual fund activities because permissible activities do not involve "issue, flotation, public sale, or distribution" of securities. Public sale does not mean sale as a broker but rather sale as an underwriter or dealer.[27] The mutual funds (i.e., investment companies) to which banks and operating subsidiaries provide advice and services may engage in these activities, but they are not "affiliates" of the bank under the meaning of that term in Section 20.[28] With respect to Section 32, the OCC has not permitted interlocks between the bank and its operating subsidiaries and any entity engaged in "issue, flotation, underwriting, public sale, or distribution" of securities. The directors, officers, and employees of mutual funds and the independent distributor have not overlapped with those of the bank and the operating subsidiaries.

In addition, courts traditionally engage in an analysis based on the legislative history of the Glass-Steagall Act to determine whether the "subtle hazards" that the law was designed to prevent are posed by any proposed activity. These "subtle hazards," which include investor confusion and conflicts of interest, are controlled by the terms of the Investment Company Act, the *Interagency Statement on Retail Sales of Nondeposit Investment Products*, Sections 23A and 23B of the Federal Reserve Act, safety and soundness requirements, and supervisory conditions imposed by the OCC.

Operating Subsidiaries. National banks have established operating subsidiaries for approximately 28 years under OCC regulations first issued in 1966. Operating subsidiaries enable banks to use a different organizational structure to conduct permissible activities. The operating subsidiary is subject to OCC examination and supervision and to the same banking laws and regulations as the parent bank, unless otherwise provided by statute or regulation.

The authority for national banks to establish operating subsidiaries is based on the National Bank Act. That Act allows banks to exercise certain enumerated powers and "all such incidental powers as shall be necessary to carry on the business of banking."[29] The Act gives banks broad authority to engage in the business of banking and to exercise powers reasonably necessary to conduct that business.[30]

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[23] *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993).
[24] *See Securities Industry Ass'n v. Clarke*, 885 F.2d 1034, 1049 (2d Cir.), *cert denied*, 493 U.S. 1070 (1990); OCC Interpretive Letter No 388
[25] *SIA v. Bd. of Governors of the FRB*, 468 U.S. 137, 149 (1984) ("*Bankers Trust I*"); *Bankers Trust II*, 807 F.2d at 1057.
[26] *See* Glidden Letter (January 14, 1988); Interpretive Letter No. 332 (March 8, 1985); *see also* Federal Reserve Board Sovran Letter (July 1986)

[27] *SIA v. Bd. of Governors of the FRB*, 468 U.S. 207, 218 (1984) ("*Schwab*").
[28] *See* 12 U.S.C. 221a.
[29] *See* 12 U.S.C. 24(7).
[30] *See* OCC Letter No. 494 (December 20, 1989), reprinted in [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

The incidental powers of national banks include, at a minimum, all powers that are "convenient and useful" to express powers.[31] Many courts and the OCC believe that incidental powers are broader and include activities similar to traditional banking functions. As the Ninth Circuit held in 1977, the incidental powers standard "must be construed so as to permit new ways of conducting the very old business of banking."[32]

The establishment of operating subsidiaries that carry on the business of banking falls squarely within the incidental powers of banks under both the narrow and broader view. These subsidiaries are a "convenient and useful" means of conducting banking business.[33] Because establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. 24(7) provisions prohibiting purchases of corporate stock.

Federal Securities Laws and Regulation

Many banking companies choose to conduct brokerage operations such as mutual fund brokerage in separate subsidiaries or affiliates of the bank. Those separate entities are regulated by the SEC and the NASD in the same manner as any other nonbank broker. Moreover, such entities are subject to additional oversight under the federal banking laws. Similarly, many banks conduct investment advisory activities in separate companies that are regulated under both the Investment Advisors Act and federal banking laws.

Congress provided certain bank exemptions from the federal securities laws by excluding banks from the definition of broker/dealer under the Securities and Exchange Act of 1934 and from coverage under the Investment Advisers Act of 1940. However, banks are still subject to a comprehensive regulatory scheme that addresses many of the same types of concerns as the federal securities laws. For example, those banks that conduct these activities under the exemptions from the federal securities laws are subject to:

- Anti-fraud provisions under Section 10b of the Exchange Act and Rule 10b-5;

- The *Interagency Statement on Sales of Nondeposit Investment Products*;

- Record-keeping and confirmation requirements for brokerage customers under 12 CFR 12;

- Fiduciary regulations at 12 CFR 9 and fiduciary obligations imposed by state law;

- The same restrictions that apply to nonbank investment advisors in the Investment Company Act of 1940, for national banks acting as investment advisers to registered investment companies;

- SEC examinations of national banks acting as investment advisers to registered investment companies;

- Restrictions on transactions with affiliates imposed by Sections 23A and 23B of the Federal Reserve Act; and

- Enforcement actions brought by their primary banking regulator, pursuant to 12 U.S.C. 1818, for violations of any law or regulation, unsafe or unsound banking practices, or for violations of any conditions imposed in writing by the appropriate federal banking agency in connection with the grant of any application or other request by the bank.

Banks are thus subject to a combination of banking and securities laws and supervision by bank and securities regulators. To the extent Congress has exempted certain bank functions from the securities laws, the primary regulators of banks operating in those areas have the authority and the responsibility to ensure that banks conduct those activities safely, soundly and in the best interests of the investing public. Should the OCC find that additional specific regulation is warranted for these activities, we will certainly take appropriate action, including adopting any needed regulations and/or imposing appropriate conditions in connection with the grant of bank applications related to securities activities.

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[31] *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).
[32] *M & M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978).
[33] *See* 12 CFR 5.34, and *see also* 12 CFR 7.10(c)(2) (repealed).

Remarks by Eugene A. Ludwig, Comptroller of the Currency, before the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition, on bank supervision, Chicago, Illinois, May 12, 1994

It is an honor and a pleasure to speak at this prestigious conference. The proceedings of this conference — especially over the last decade or so — have become required reading for anyone taking a serious interest in banking supervision, the subject of my talk today.

Given the announcement of Silas Keehn's retirement, I want to take this opportunity to recognize Si for the visionary guidance and direction he brought to this conference when he became president of the Federal Reserve Bank of Chicago in 1981 — qualities that have contributed greatly to this conference's success.

Supervising an Evolving Industry

As I noted a moment ago, I am here today to talk about banking supervision — and more particularly, how and why the course of banking supervision must change, and how we at the Office of the Comptroller are engaged in changing it. These are not new interests for us. Banking supervision has been our business for the last 130 years. And for most of that time, it has been our only business.

Accordingly, we bring to banking supervision a unique insight that is the product of our long experience, an insight well expressed by one of my distinguished predecessors, James J. Saxon, who in 1964 addressed bank structure and competition succinctly when he wrote: "The banking structure that is most ideal in terms of the public need will vary with the changing requirements for banking services and facilities. Like the operating powers of commercial banks, the structure of the banking industry must continuously be adapted to emerging demands and opportunities."

Because society and the economy evolve, banking, and therefore, bank supervision must evolve in tandem with them. Just as a failure to evolve makes banking less relevant to the needs of the economy, a failure to evolve makes bank supervision less effective in assuring efficient financial intermediation. Banking supervision, therefore, must be a dynamic process, not a static structure of law and rules. We can never have a single answer to the question "What is the best way to regulate banks?" because the answer changes as circumstances change.

For the last three decades, the economy and the financial services sector have changed constantly. By fits and starts, banking has been partially deregulated. Bank supervisors have had to work hard and think hard to keep abreast of these changes. It is fair to say that since the end of the 1970s, banking has experienced something of a deregulatory revolution: interest rate deregulation, including nationwide interest-paying checking and money market deposit accounts; interstate banking through the regional compacts that began in New England and the Southeast; elimination of usury ceilings; discount securities brokerage; authority for so-called Section 20 subsidiaries to underwrite corporate debt and equity — the list goes on and on.

As a result of these changes, bank supervisors today permit banks to engage in — and banks do engage in — a far wider range of activities than they did 20 years ago. The expanding range of bank activities has placed new demands on bank supervisors — demands that the supervisory system has not always found easy to meet. For example, supervisors have had difficulties accurately measuring the extent of bank diversification and the effect of diversification on risk. Moreover, monitoring and assessing off-balance sheet risks accurately have proven to be challenging. And supervisors have had difficulty coming up with an approach to measure accurately an institution's overall risk in a cost-efficient manner. Finally, a current wrinkle in the problem of risk identification is how to distinguish between true hedging and simple speculation.

This disequilibrium between banking deregulation and bank supervision has certainly contributed to problems in the banking industry. Most recently, from 1980 through 1993 about 1,500 commercial banks and almost 1,200 thrifts failed. To be sure, a number of factors — macro-economic conditions, real estate and oil cycles, and nonbank competition — contributed to these failures. But supervision deserves a portion of the responsibility for its failure to anticipate these developments or respond early enough or effectively enough to them.

In this regard, the experience of the thrift industry offers special food for thought. Although the Bank Insurance Fund did not require general budget infusions, the thrift debacle imposed direct costs on taxpayers of roughly $175 billion, measured on a present value basis in 1990 dollars. Further, through misallocating investment resources, the thrift debacle inflicted a severe drag on the national economy. Many of those thrift failures resulted, in part, from efforts to grow the thrift industry

out of its financial problems by deregulating it, thus — the train of reasoning ran — making it more competitive and, therefore, more profitable.

Competition, in and of itself, was not the problem with that approach. We made the decision to promote a competitive banking system years ago. Competition is desirable: it makes the economy stronger. And it offers the American consumer a wider array of products at better prices than consumers anywhere else enjoy.

The flaw in the reasoning of the 1980s was the assumption that competition by itself would inevitably bring benefits that the institutions would reap. Instead, absent an effective supervisory regime, greater competition simply brought the failure of large numbers of firms at great cost to the public and the industry. I, for one, would prefer not to relive the depository industry's experience of the 1980s as deregulation of banking continues.

And deregulation will continue.

Our challenge in public policy is to restore and maintain the dynamic balance between the business of banking, bank supervision and the demands of the market and the economy. To meet the demands of the economy, banks must remain competitive. However, the lesson of recent history is that regulatory and statutory developments that enhance bank powers must proceed hand-in-hand with supervisory reform. Without adequate supervision — which to my mind includes effectively monitoring bank activities, enforcing regulations for closing institutions, attending to possible sources of systemic risk — expansion of the bank franchise carries with it implications for the deposit insurer and for the economy as a whole that are potentially unacceptable.

How best to supervise a banking industry whose activities continue to expand, however, has been the subject of much recent debate, with opinion sometimes clustering around two extremes.

At one extreme, advocates argue that we can structure the corporate form of a financial organization in a way that insulates its bank component and thus the Bank Insurance Fund and, to some extent, the economy, from risk — a hands-off approach. The proposal to create a "narrow" bank is the best example of this approach. At the other extreme are those who argue that only a highly developed supervisory apparatus that monitors every risk and makes sure that every risk is limited can be effective — a hands-on approach.

In the real world, supervisory practice falls between the two extremes, and the business of making supervisory policy centers very much on where to draw the line between them.

Constant change in banking calls into question the effectiveness of any regulatory scheme based primarily on corporate separateness. The concept of insulating a bank against risk through corporate structure projects the allure of elegant simplicity and regulatory minimalism. But while corporate separateness may be a necessary condition of risk management, standing alone it is rarely, if ever, sufficient.

In the long run, markets will erode any arbitrary barrier. Even in the short run, expedience may lead bankers simply to ignore it. The corporate veil unravels and rips.

The experience with Real Estate Investment Trusts in the 1970s provides a classic example of how corporate separateness alone can be insufficient in insulating banks from risk.

Many of you here today heard the late Bill Taylor say that fire walls can become walls of fire. This is still a valuable caution. In fact, Bill Taylor argued for the other approach, a hands-on approach, at this conference in 1988, an approach which he said involves:

(a) setting standards for the activities and operations of banks that will establish a proper balance between bank risk-taking on one hand and the ability of banks to manage those risks and to have capital adequate to absorb losses from such risks on the other;

(b) properly monitoring the operation of banks to see that they meet these standards;

(c) taking proper steps either of an informal or formal nature to see that banks implement measures to correct problems when they arise; and

(d) finally shutting down or reorganizing a bank in an orderly way when its problems can't be corrected and capital is exhausted.

I agree. As I have said on earlier occasions, we have learned — through a difficult and expensive education — that when the world and our vision of the world become too far separated, we invite disaster. The only way to prevent that separation from occurring is to make a constant effort to be aware of what is going on in the world. That effort is the foundation of the hands-on approach.

But this hands-on approach does not mean that supervision should replace management. Rather, I would add to the Taylor model two refinements, which factor management into the supervision equation.

The first refinement: three questions should be asked of any new activity for banks. Can the risk of the new activity be adequately monitored? Can monitoring be verified, by the supervisors, by management, by directors, by shareholders, by creditors? Can the risk be managed? If the answer to any question is "no," we should take a hard look at any banking organization that engages in the activity.

The second refinement: bank supervisors must concentrate their attention and their resources on the risks with the greatest potential implication for the economy and the Bank Insurance Fund. These risks fall into two categories.

The first involves a sudden, usually unexpected, collapse of confidence in a significant portion of the banking or financial system with potentially large real economic impacts. Let us call these "systemic" risks. The second involves macro-economic cycles, new product trends and other developments that may not be sudden, but that affect large portions of the industry and carry substantial safety and soundness implications. Just to confuse you, I will call these "systemwide" risks.

To date, the approach of bank supervisors to these risks has been primarily *ad hoc* and crisis driven. That needs to change. The Office of the Comptroller is engaged in a variety of initiatives to refocus our supervisory effort to address these risks better and more consistently.

One practical implication of the need to focus on these risks is a differentiation between the supervision of large banks and small banks — a differentiation that the Office of the Comptroller is making. By virtue of their size and the complexity of the types of activities in which they engage, larger institutions pose relatively greater systemic risk than do smaller institutions. For each of our largest banks, we now develop an individual risk profile based on all the risks the bank takes on. We then try to determine whether the risks are appropriatefortheindividual institution, given its resources, and whether the controls the institution has in place are appropriate to the risks. On the other hand, stable, small, community-oriented banks engaged in traditional banking activities tend to have a common risk profile. For those reasons, among others, the Office of the Comptroller will soon begin examining these small banks against a common standard of performance, rather than against the more intensive and intrusive managerial standards we use now.

Conclusion

In 1963, when this conference began with 20 or so analysts sitting around a table, there were about 13,300 commercial banks in the United States. As of the end of last year, there were fewer than 11,000, and some of you have predicted the total will drop below 10,000 by the end of the century. In 1963, the biggest event in American banking, one intimately associated with the origins of this conference, was a landmark decision of the U.S. Supreme Court enjoining the proposed merger of two large banks in Pennsylvania. Just last week, the Office of the Comptroller approved a merger of the second-largest bank in Pennsylvania and the nation's sixth largest mutual fund company. In 1963, a handful of New York City banks took advantage of a newly enacted New York State law that allowed them to branch into suburban counties. Today, legislation is pending in Congress that would lead to nationwide bank branching. When was the last time you heard anyone say: "Things never change in banking"? That blanket statement has been replaced with the question: "What does the future hold?"

The Office of the Comptroller will make sure that the future holds a system of bank supervision that addresses the growing complexity and technical sophistication of the industry. Thank you.

Statement of Eugene A. Ludwig, Comptroller of the Currency, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, on supervision of banks' derivatives activities, Washington, DC, May 25, 1994

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to participate in today's hearing on derivative financial instruments. As supervisor of national banks, the Office of the Comptroller of the Currency (OCC) believes that the safety and soundness issues associated with bank use of derivatives are of great importance. The recent expansion of derivatives markets has provided banks and the public with important benefits: financial derivatives transactions allow banks and other market participants to manage their financial risks more precisely and efficiently than with other instruments, and they also often provide users with the lowest cost funding alternatives by reducing transaction costs and, in some cases, by exploiting arbitrage opportunities across financial markets. At the same time, the recent growth in derivatives markets has created new challenges: supervisors must ensure that banks using these often-complex instruments clearly understand and properly manage the associated risks and that banks have the financial resources to withstand market volatilities. In response, the OCC has devoted resources to improving our understanding of these issues and to strengthening our supervision of bank derivatives activity.

My testimony begins by describing the OCC's recent initiatives to augment its supervision of bank derivatives activity. Then, as requested by your invitation letter, my statement provides the OCC's comments on the General Accounting Office's (GAO) report examining the development and trading of derivative financial instruments by financial institutions and their customers. Because the final version of the GAO's report was released only last week, my staff has not had the opportunity to review its findings and recommendations in detail. I therefore confine my remarks to preliminary comments on the report's more general findings.

The remainder of my testimony responds to the issues raised by your letter of invitation: the potential for derivatives to contribute to systemic risk, the nature and adequacy of internal controls and risk management systems at banks and nonbank end-users, the nature and adequacy of existing protections afforded to corporate and other end-users of derivatives, the nature and adequacy of the public disclosures provided to investors regarding derivatives holdings, and the possible need for any changes in the regulatory treatment of derivative financial instruments or the adoption of remedial legislation relating to such instruments.

OCC Supervisory Initiatives

The OCC has taken a number of important steps to increase our supervision of the derivatives activities of national banks. Soon after I became Comptroller, I recruited Douglas E. Harris, a Senior Attorney and Managing Director of J. P. Morgan and Co. with substantial expertise in the derivatives activities of major Wall Street securities firms and commercial banking organizations, as my Special Policy Advisor. Mr. Harris formed and leads the OCC's Derivatives Task Force, which has produced additions to and refinements of OCC policy in this area.

One of the first products of the Task Force was OCC's Banking Circular 277 (BC 277), Risk Management of Financial Derivatives, which we issued on October 27, 1993 to the chief executive officers of all national banks. We were the first banking agency to issue guidance to bank management on managing the risks of financial derivatives. The circular states that banks should adopt systems and controls to properly measure and monitor the individual and aggregate risks associated with their derivatives portfolios. It also advises banks to set up and follow appropriate risk limits. BC 277 includes some separate standards for dealers and end-users. (Dealers are banks that take on principal risk and actively provide market liquidity to other dealers; and end-users include banks that use derivatives to actively manage their balance sheet risks.) BC 277 sets forth best practices and safe and sound procedures for managing risk, and we expect all national banks—end-users and dealers—to apply the guidance not only to their derivatives activities, but also to risk management generally, including their non-derivatives activities, to the extent possible.

On May 10, we issued 23 pages of further guidance to banks in the form of commonly asked questions and our answers to them. The questions and answers cover such topics as the duties of senior management and the board of directors for oversight of derivatives activities, monitoring the interconnectedness of risks, and the responsibilities of dealers toward end-users. We are developing supplemental examiner guidance to accompany BC 277, which will include detailed, comprehensive procedures for examining the derivatives activities of national banks. We plan to issue this guidance shortly.

The OCC is also participating in several domestic and international efforts to coordinate regulation of derivatives use. Last September, we helped to create an informal interagency task force to look at supervision of derivatives by bank and thrift regulators. The task force, which includes staff from the OCC, the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), was organized to develop coordinated derivatives policies and procedures among the agencies. The task force is also working on accounting and disclosure issues. The group has several goals: to share information on the extent of banks' involvement in derivatives activities; to discuss ways of achieving greater cooperation in the examination process; and to review and evaluate procedures for risk valuation, pricing, and stress testing.

The OCC has participated in the Working Group on Financial Markets, led by Secretary Bentsen through his representative, Under Secretary for Finance Frank Newman. The Working Group was originally established in the wake of the 1987 market crash to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets, and to maintain investor confidence. The group, which includes the chairs of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, has resumed its regular meetings and has added derivatives, and interagency coordination of derivatives regulation, to its agenda.

In addition, the OCC is working with the other bank supervisors, both in the U.S. and abroad, to modify existing capital requirements to address banks' use of derivatives instruments. We are participating in the Basle Committee's international efforts to develop new standards for market risk and to recognize legally enforceable bilateral netting in the computation of a bank's risk-based capital. With the FRB, the OCC issued a notice of proposed rulemaking to amend our risk-based capital standards to implement the Basle Committee's netting proposal on May 20.

Based on our recent examinations of national banks and discussions we have had with market participants, it appears that, for the most part, national banks, and especially the dealer banks, have committed considerable technological and human resources to managing and controlling the risks arising from their derivatives activities. The OCC continues to have concerns about these activities, however.

First, our examiners have found that the extent of senior management and board knowledge and oversight of bank derivatives activities at a few national banks is not as broad as we would like. While senior management and the board of directors may rely on inside and outside professionals to manage their derivatives activities, proper knowledge and oversight on the part of senior managers and the board is a critical element of our guidance and of sound risk management. Hence, our examiners have informed the management at those banks that we expect them to correct any deficiencies in this regard.

Second, we are paying particular attention to bank trading and use of certain specialized derivative instruments, including certain types of collateralized mortgage obligations, some structured notes, and certain highly-leveraged over-the-counter (OTC) transactions. The markets for such instruments tend to be less liquid, their values more volatile when compared with simpler, shorter-term derivatives instruments, and their risks may be less easily understood. The OCC is examining whether further regulatory action on these instruments is appropriate.

Third, the proprietary trading units of some of the dealer banks actively trade cash and derivative instruments to establish risk positions for the bank that are independent of the bank's other trading and risk management positions. These proprietary trading units represent only a small portion of the bank's trading activities, and they are intended to make use of the powerful research capabilities and portfolio management expertise that the banks have in place to serve customer needs. We supervise such trading operations closely to ensure that national banks operating them are adequately controlling the associated risks. Nevertheless, the central role that banks play in the economy, and the fact that federally insured institutions are engaging in these activities, raise public policy issues; as a result, the OCC is devoting further attention to this area. We do not believe, however, that requiring banks to confine their proprietary trading activities to separately capitalized subsidiaries would address these issues. In fact, we have some concerns that doing so could increase the risk these activities pose to the financial system.

OCC Comments on the GAO's Findings and Recommendations

As I have noted, I will limit my comments to the report's major findings and recommendations. In general, the OCC supports and is working to implement several of the GAO's recommendations, including those calling for greater coordination and harmonization among regulators and other groups overseeing derivatives activities by financial institutions.

Recommendation 1: Develop and maintain accurate, current, and centralized information that is accessible

to all regulators, including information on the extent of major OTC dealers' counterparty concentrations and the sources and amounts of their derivatives earnings.

Banking Circular 277 states that banks should gather and use such information for their risk management purposes, and certainly the additional reporting requirements that GAO recommends would provide useful information for supervising bank trading exposure. At present, our examiners collect, as part of our regular supervision of bank derivatives activity, information that we require for our supervisory needs. In particular, BC 277 states that a national bank's risk management procedures should include reports to senior management and the board of directors that accurately present the nature and level(s) of risk the bank is taking and document compliance with approved policies and limits. OCC examiners obtain and review such information during the regular examination process, with the objective of focusing on the risks to which banks are exposed. At each of the seven dealer banks and at the largest end-user banks, there are full-time, resident examiner staffs who continuously monitor the bank's risk, including the risk from its derivatives activities.

However, like many market observers, we believe that the public disclosures made by financial institutions engaging in derivatives activities do not give sufficient information about the extent of those activities and their associated risks. We support the accounting profession's efforts to improve disclosures for all financial institutions. With regard to banks, we note that several major dealer and active end-user banks have made substantial improvements in the level and detail of their disclosure of derivatives activities in their 1993 Annual Reports, and we support the banking industry's efforts to voluntarily improve disclosures. In addition, the OCC is participating in the interagency task force's efforts to improve public disclosures of bank derivatives activity.

In December 1993, the Federal Financial Institutions Examination Council (FFIEC), of which OCC is a member, adopted the task force's proposal to expand regulatory reports to include information on non-performing derivatives contracts and to enhance disclosure about derivatives held in a trading or dealing capacity. These changes were effective in the March 31, 1994 call reports.

In March 1994, the FFIEC approved the task force's proposal for additional call report disclosures that would provide regulators with more consistent data and improve public access to data on banks' derivatives activities. On March 9, the FFIEC published in the *Federal Register* a proposal that would require banks to increase their disclosures of derivatives positions and revenues. The comment period for the proposal ended on May 9, and we are evaluating the 39 comments received by the FFIEC.

Specifically, the proposal would expand the current disclosures of notional values by requiring banks to report separately their exchange-traded and OTC derivatives transactions. Such information would provide additional information on new lines of business and concentrations in particular markets or products. The proposal would also require banks with over $100 million in assets to report data on the positive and negative fair values of outstanding derivatives contracts. Those data would allow analysis of gross credit risk exposures from these activities. In addition, in anticipation of the aforementioned possible change in the netting rules for risk-based capital purposes, the proposal would require banks to report, as a single number, their net current credit exposure. In calculating this exposure, the proposal would recognize legally enforceable bilateral netting arrangements across all derivatives contracts, which would provide a more accurate estimate of an individual bank's credit risk.

Also under the proposal, banks with over $100 million in assets would be required to report, as of March 31, 1995, additional income data related to off-balance-sheet items. Those banks would be required to report the impact of off-balance-sheet items on their net interest margin and on their non-interest income. The new data would enable bank supervisors and the public to better analyze the nature of such activities and the degree to which they create exposure to the bank's capital.

Recommendation 2: Develop and adopt a consistent set of capital standards for OTC derivatives dealers sufficient to ensure that all of the major risks associated with derivatives as well as legally enforceable netting agreements are reflected in capital.

As described below, OCC's capital standards currently address credit risk associated with bank use of derivatives, and we are working on proposals to amend our standards to incorporate market risk and to recognize legally enforceable netting agreements. However, while the OCC supports the GAO's view that capital standards are an important tool for supervising the risks associated with bank use of derivatives, there are a number of reasons why we do not believe that refining our risk-based capital rules to quantitatively incorporate the operational, liquidity, and legal risks stemming from bank use of derivatives would be necessarily the most productive strategy for supervising those risks.

First, although we rely on our capital standards as a supervisory tool, we place an even greater emphasis

on ensuring, through on-site examinations, that the bank understands, manages, and controls the risks arising from its use of derivatives instruments as they interact with the bank's other sources of risk. As we said previously, in each of the seven dealer banks that OCC supervises, a full-time examiner staff continuously monitors risk management information.

Second, when compared with market and credit risk, liquidity, operational, and legal risks tend to be more difficult to quantify. For example, the OCC is not aware of any methodologically sound technique for quantifying operational or legal risk.

Third, banks are required to maintain a minimum capital leverage ratio, which is in addition to the risk-based requirement. The leverage ratio provides a cushion against risks (e.g., legal and operational risk) that arise from the banks' derivatives activities, but are difficult to quantify.

Fourth, because such risks arise in the context of many bank activities, not just derivatives activities, we would address them in the context of capital standards that would apply to risks arising from any bank activity.

In addition, the OCC strongly believes that, given the truly global span of derivatives markets, comparable capital regulations among banking agencies and countries would help to prevent competitive inequalities. Hence, the initiatives that OCC has taken to incorporate risk arising from bank derivatives transactions into our capital standards, which I describe below, have been in conjunction with the U.S. banking and thrift regulators and foreign banking regulators.

The OCC's risk-based capital requirement (12 CFR 3, Appendix A) imposes an explicit capital charge for the current and potential credit (counterparty) risk exposure in financial derivative products. This capital charge applies to interest rate and foreign exchange (FX) swaps, forward rate agreements, and purchased interest rate and FX options[1] and to newer derivative products, including commodity and equity-index swaps.

The OCC believes that the inclusion of off-balance-sheet counterparty (credit) exposures into capital standards was an important and necessary step in ensuring that banks maintain adequate capital for derivatives activities. The OCC also recognizes, however, that the current standards do not consider explicitly market risk and that, as new products or activities emerge in the derivatives markets, the risk-based capital standards may need to be revised. Hence, we are actively involved in the several initiatives, described below, that would result in modifications and additions to the current risk-based capital treatment of derivatives. The scope of these initiatives includes credit risk, market risk, and foreign exchange rate risk. We are pursuing them jointly with the other U.S. banking agencies (primarily the FRB and the FDIC), and with foreign supervisors through the Basle Committee on Bank Supervision.

Credit Risk

The Basle Committee Proposal on Netting would recognize legally enforceable bilateral netting arrangements when computing a bank's counterparty credit risk exposure in derivatives. Currently, only netting by novation[2] is permitted. Although this proposal would have the effect of reducing the current capital charge for certain derivatives initially and in some instances, the OCC believes that this proposal, by encouraging the use of enforceable bilateral netting arrangements, will reduce the level of settlement risk and, therefore, systemic risk in the derivatives markets.

The Basle Committee released a consultative paper on this proposal in April, 1993, and the OCC and the FRB are working to implement the Basle Committee initiatives through the rulemaking process. We have issued a notice of proposed rulemaking, which was published in the *Federal Register* on May 20, to seek public comments on this topic. The comment period will end on June 20.

Market Risk

The FDICIA Section 305 Proposal would establish a system for measuring a bank's overall interest rate risk exposure and provide a basis for requiring capital for exposures that exceed a threshold level. Derivatives exposures would be fully incorporated into the risk measure.

The U.S. banking agencies issued a joint Notice of Proposed Rulemaking on this proposal on September 14, 1993. The comment period for the proposal closed on October 29, 1993.

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[1]Contracts that are traded on an exchange requiring the daily payment of any variations in the market value of the contract, such as futures traded on U.S. exchanges, are not subject to the capital requirements.

[2]Netting is the agreed offsetting of positions or obligations by trading partners or participants in a system. Netting reduces a larger number of individual positions or obligations to a smaller number of positions. Novation refers to the satisfaction and discharge of an existing contractual obligation by the substitution of new contractual obligations. Netting by novation occurs, therefore, when the existing contractual obligation is extinguished by the subsequent new obligations.

The Basle Committee Proposal on Market Risk for Trading Books would incorporate a capital charge for the market risk of equity and debt derivatives that are part of a bank's trading activities. This charge would be in addition to the current risk-based capital charge for counterparty (credit) exposures. The charge would *not* be applied to derivatives held outside of trading portfolios, such as those used to hedge structural balance-sheet positions.

The Basle Committee issued a consultative paper on this proposal in April 1993, and the consultative period closed on December 31, 1993. Any proposal to modify the OCC's current risk-based capital guidelines that might result from this consultative paper would be issued for full public comment through the rulemaking process before being adopted. The OCC would carefully consider these comments before adopting any proposals.

The Basle Committee Proposal on Foreign Exchange Risk would introduce a capital charge on a bank's net open foreign currency and precious metals positions. Any foreign exchange or precious metal derivative instrument would be included in determining a bank's net open position. This charge would be in addition to any applicable counterparty or market risk capital charges that are under consideration by the Basle Committee.

Also in April 1993, the Basle Committee issued a consultative paper on this proposal. The consultative period closed December 31, 1993. As with the market risk proposal, the OCC would seek public comments through the rulemaking process and carefully consider those comments before adopting any change to its current risk-based capital guidelines.

Recommendation 3: Establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers. Internal control reporting by boards of directors, managers, and external auditors should include assessments of derivatives risk-management systems.

Prudent management of financial derivatives activities requires that senior management and the board of directors at banks engaged in such activities have timely, accurate, and comprehensive information about the level and nature of the risks inherent in those activities. Hence, OCC policy requires senior management and the board of directors of all national banks engaging in derivatives transactions to establish comprehensive risk management systems. As BC 277 states, those systems should include auditing procedures and timely, accurate reports to senior management and the board on the nature and level(s) of risk taken and compliance with approved policies and limits. The auditing procedures should ensure the integrity of measurement, control, and reporting systems, and compliance with approved policies and procedures. In addition, the circular emphasizes that reports to senior management and the board of directors should be prepared by individuals who are independent of the bank's risk-taking unit. Because we recognize that banks can meet those standards in a variety of ways, we do not require banks to establish a particular structure for such functions, (e.g., we do not require the bank to set up a separate committee to oversee the audit function). Instead, we allow the bank to choose the form that enables it to meet our standards in a manner that is efficient and most appropriate to its circumstances.

BC 277 also states that audit coverage should be adequate to ensure timely identification of internal control weaknesses and/or system deficiencies, and that it be performed by competent professionals who are knowledgeable of the risks inherent in financial derivatives transactions. BC 277 notes that the bank's audit procedures should include: (1) appraisals of the soundness and adequacy of accounting, operating, and legal risk controls and (2) tests for compliance with the bank's policies and procedures. For end-user banks, audit coverage is likely to be included within the scope of audits of the interest rate, foreign currency, and liquidity risk management functions. BC 277 emphasizes that dealer banks should have audit coverage that is sufficient to assess the nature and increased complexity of the other risks, such as credit, market, and operational risks, associated with these businesses.

Furthermore, BC 277 emphasizes that senior management of each national bank engaging in derivatives transactions should have a unit or individual responsible for measuring and reporting risk exposures that is independent of the trading or sales function. The risk monitoring and control function includes monitoring compliance with policies and risk exposure limits.

Recommendation 4: Perform comprehensive, annual examinations of the adequacy of major OTC derivatives dealers' risk management systems, using a consistent set of standards established for this purpose and including consideration of the internal control assessments performed by boards of directors, management, and auditors.

The OCC supports and is in substantial compliance with this recommendation, as it applies to national banks. Together with the forthcoming examiner guidance, BC 277 provides a consistent set of standards for assessing national banks' risk management systems. A central feature of BC 277 is that it emphasizes the importance of the bank's systems to

manage the risks associated with derivatives and other bank activities. Since its issuance, we have begun to ensure that banks comply with BC 277 and have proper risk management systems in place through on-site examination and evaluation of internal risk management processes and internal controls. As noted above, there are full-time, resident examiner staffs in each of the seven dealer banks and at the largest end-user banks. Those staffs range in size from 3 to 22 examiners at the dealer banks and from 1 to 13 at the largest end-user banks. Most end-user banks are examined once every 12 months, and every national bank is examined at least once every 18 months. As with other banking activities, the examiners who are implementing BC 277 receive extensive on-the-job training in examination of bank derivatives activities under the supervision of senior examiners. The OCC also provides formal instruction for its examiners. In July 1992, the OCC created the Capital Markets Training Program (CMTP) to provide advanced technical training for examiners specializing in bank capital markets activities, including derivatives activities. Currently, 81 examiners are enrolled. In 1993, the program sponsored three seminars to address advanced topics related to the supervision of bank derivatives activities. CMTP participants also receive a newsletter that frequently includes feature articles on derivatives. OCC examiners also receive training on bank derivatives activities through a number of specialized courses, many of which are conducted by the FFIEC.

Recommendation 5: Provide leadership in working with industry representatives and regulators from other major countries to harmonize disclosure; capital; legal requirements including netting enforceability; and examination and accounting standards for derivatives.

As noted above, the OCC strongly supports the adoption of uniform capital regulations among banking agencies and countries to prevent competitive inequalities and to ensure prudential banking standards in all major markets. We have participated in developing the previously mentioned Basle Committee proposals to recognize reductions in credit risk resulting from the use of legally enforceable netting arrangements and to incorporate measures of market risk on foreign exchange, precious metal, and traded debt and equity positions, including derivatives positions. We will continue to work with the other banking regulators, both here and abroad, to develop consistent, systematic approaches to the supervision and regulation of derivatives activity in banks.

In another section of the report, the GAO notes that its review of examination reports done by OCC and the FRB and the supporting workpapers has caused it to raise a concern that the banking regulators may not be sufficiently testing internal controls. In fact, the workpapers may not include all of the documentation for the work conducted during an examination; and a review of the workpapers by themselves may not capture all of the work conducted during the examination. For instance, much of the information used during the examination, such as bank policy and procedure manuals, is kept by the bank's resident examination staff or returned to the banks, and examiners may not duplicate all of this information for the workpaper files.

OCC examiners routinely review internal controls during their evaluation of the bank's risk management process. Because of our perception that internal controls are an integral part of the risk management process, however, examiners may not specifically rate the adequacy of internal controls outside of their evaluation of the overall risk management system.

In addition, as the GAO report states, new regulations the banking agencies have recently adopted pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) require management at banks with $500 million or more in assets to conduct their own evaluations of the effectiveness of the internal controls at their institutions, and to report to their regulators on their evaluation.

When evaluating a bank's internal controls, examiners review the results of any work performed by internal and external auditors—including the auditors' detailed testing of controls—and the supporting workpapers. Guided by examination materials that address internal controls (e.g., the *Comptroller's Handbook for National Bank Examiners* and the OCC's *Source Book*), examiners review the scope of audit work to ensure that the bank has addressed all major control areas. If we find that the bank's audit scope is incomplete, we criticize the audit work and require bank management to address our criticisms by expanding the audit. If the bank's audit reports identify deficiencies in key control areas, we verify that the bank has taken corrective action.

The GAO report also notes that the guidelines which the federal bank regulators have issued on bank use of financial derivatives do not have the weight of regulation, and that it can be more difficult for the regulators to obtain corrective action when a bank fails to comply with the guidance.

In fact, as noted above, Banking Circular 277 sets forth procedures for the safe and sound management of a bank's derivatives activities. Pursuant to 12 U.S.C. 1818, the OCC has the authority to take enforcement action regarding any unsafe and unsound banking practice arising from a national bank's noncompliance

with BC 277 or other regulations or guidelines. If an examiner finds that a national bank is not in substantial compliance with the BC 277, he or she will notify OCC management and inform the bank's board and senior management that we expect the bank to correct the problem. If informal measures fail to address the problem to our satisfaction, we may then commence an informal or formal enforcement action against the bank requiring the bank to take corrective action, on the grounds that the bank is engaging in an unsafe and unsound practice.

Because guidelines are more flexible than regulations, they allow us to respond more quickly to the pressing issues at hand, and to adapt to a quickly changing aspect of this industry, while preserving the ability of banks to respond efficiently and flexibly to new opportunities. Moreover, because the guidelines represent standards for the safe and sound conduct of a bank's derivatives activities, we have all the necessary powers to enforce them.

Additional Issues Raised by the Invitation Letter

Your letter of invitation raises a number of additional important issues related to bank use of derivatives. I will respond to each in turn.

(1) The potential for derivatives to contribute to increased systemic risk in the financial system (including the potential for such financial instruments to contribute to increased levels of volatility or excessive speculation in the stock and bond markets).

The growth of derivatives markets, coupled with rapid changes in technology and telecommunications have brought financial markets closer together, with the result that financial pressure at an individual firm might amplify market dynamics, which in turn could create increased financial pressure at many other firms. As bank supervisors, we at the OCC are attentive to the risks associated with the markets in which banks participate, as well as banks' vulnerability to systemic events in those markets, and we have taken steps to minimize banks' exposure to systemic risk.

In particular, we are concerned about the liquidity of some of the markets in which banks participate. Rapid movements in market conditions could lead to simultaneous efforts by many banks and other market participants to limit their exposures, and some markets may not be sufficiently liquid to allow all participants to execute their desired transactions in an orderly fashion. To address this concern, BC 277 underscores the need for bank managers to establish effective controls over the market/product and cash flow liquidity exposure arising from financial derivatives activities.[3] For example, the circular states that banks' market risk limits should formally address their exposure to market/product liquidity risk, and that the bank should have liquidity policies to formally govern its exposure to cash flow gaps (from intermediate payments or settlements) arising from financial derivatives activities. The circular also states that banks should manage their liquidity exposures resulting from financial derivatives activities as an integral part of their day-to-day operations, as well as their contingency and liquidity planning processes.

In addition, as BC 277 makes clear, the OCC believes that a crucial defense against systemic risk is for each bank to implement effective risk management systems. The circular and the forthcoming examination guidance stress the need for all banks to have risk management systems in place that are sufficient to measure, analyze, and control each of the risks arising from derivatives activities. Those systems should ultimately enable the bank to monitor, limit, and control its interconnection risk—the exposure resulting from the covariance between one or more risk factors. BC 277 also emphasizes the need for banks to anticipate the market, credit, and liquidity risks arising from their derivatives activities through use of stress testing—the evaluation of risk exposures under various scenarios that represent a broad range of potential market movements and corresponding price behaviors, including those that go beyond historical and recent market trends. In addition, the circular states that banks should hold sufficient capital to absorb potential losses from those risks.

(2) The nature and adequacy of internal controls and risk management systems at both the financial intermediaries and the corporate or other end-users of derivative financial instruments (e.g., mutual funds, municipalities, pension plans or other institutional investors).

As part of the examination process, the OCC reviews information on the nature and adequacy of internal controls and risk management systems of national banks and their customers. We can consult with the other regulators regarding the systems and controls at other banks. We do not collect data, however, about the nature and adequacy of internal controls and risk management systems found in corporate or other end-users of derivative financial instruments that are not

[3]As BC 277 states, in the context of financial derivatives products, liquidity risk takes two forms; market/product liquidity risk and cash flow risk. If there is insufficient market activity or prices are not available, a bank risks loss due to its inability to exit or unwind a position. The inability to meet cash flow obligations at an acceptable price as they become due may also present a risk of loss

banks or customers of banks, and we are not aware of a systemwide source for such information.

With regard to banks, BC 277 requires banks to adopt proper internal controls as part of their risk management systems for derivatives activities, and for other activities, as appropriate. As I noted previously, the examinations that we have conducted since the circular was issued last October have given rise to concerns about the level of senior management and board oversight at some national banks. Our examiners are working with those banks to resolve our concerns in this area.

(3) The nature and adequacy of existing protections afforded to corporate or other end-users of derivatives from abusive practices in connection with sales of such financial instruments (e.g., the sale of unsuitable investments to customers, inadequate disclosures regarding the risks associated with these products).

BC 277 creates the presumption that, consistent with safe and sound banking practices, a bank dealer will not recommend transactions that it knows, or has reason to know, would be inappropriate for the customer, based on available information. Compliance with Section C1 of BC 277 is an important part of the bank's credit risk management. In particular, Section C1 states that credit officers who approve derivatives transactions should be able to determine that a proposed derivatives transaction is consistent with a counterparty's policies and procedures with respect to derivatives activities, as they are known to the bank.

A customer's ability to perform its obligations under a derivatives transaction depends, in part, on the appropriateness of the transactions to the customer's financial situation, business practices, and objectives. BC 277 provides guidance to the bank's credit officers who establish the credit lines of individual customers. In this respect, it is broadly analogous to the responsibility of credit officers to evaluate a borrower's ability to repay before making a traditional bank loan.

Section C1 emphasizes that the credit officers responsible for establishing and monitoring financial derivatives credit lines should understand the applicability of financial derivatives instruments to the risks the bank customer is attempting to manage. If the bank believes that a particular transaction may not be appropriate for a particular customer, but the customer wishes to proceed, Section C1 states that bank management should document its analysis and the information the bank provided to the customer.

Failure to comply with Section C1 can also expose a bank to reputation risk—the risk that a bank might lose a client, or be unable to compete effectively for new clients, due to perceptions that the bank does not deal fairly with clients or that it does not know how to properly manage its derivatives business.

(4) The nature and adequacy of public disclosures provided to investors regarding the derivatives holdings of public companies, mutual funds, municipal governments, and other end-users of derivative financial products.

U.S. banks currently report more information on their derivatives activities than most foreign banks are required to report, and the proposed Call Report changes will expand those required disclosures. However, the current lack of financial accounting and reporting standards applying to bank derivatives activities continues to be one of the most important issues facing bank regulators in the derivatives area. Until uniform standards are adopted, there will continue to be inconsistent accounting practices among U.S. banks and other institutions that use derivatives. The OCC will continue to work to resolve these accounting and disclosure issues, through its own efforts, by participating in the interagency task force mentioned above, and by working with the Financial Accounting Standards Board.

(5) The need for any changes in the regulatory treatment of derivative financial instruments or the adoption of remedial legislation relating to such instruments.

As my statement discusses earlier, the OCC is addressing a range of issues related to the regulation of derivatives use by national banks, and we will continue to strengthen our supervision of these activities, as appropriate.

The OCC does not believe legislation applying to national banks is necessary in the derivatives area at this time. As the OCC implements BC 277 and the pending examination guidelines, however, we will continue to evaluate the effectiveness of current policy in reaching our supervisory objectives. Should we find current measures to be inadequate, we will consider taking further action to address any areas of concern. Similarly, should we determine that our legal authority is inadequate, we will consider requesting additional authority.

Conclusion

We believe the OCC's policies and strategies for addressing supervisory and public policy concerns arising from national bank use of derivative instruments are sound and appropriate. We are continuing to make progress toward addressing the particular concerns that I have noted in the introduction to my testimony,

and that the GAO documented in its report. To that end, we are working unilaterally, with the U.S. banking agencies and other financial regulators, and with our supervisory counterparts abroad. We remain committed to participating in joint efforts to adopt and promote regulations and policies that are appropriate for these evolving markets.

Remarks by Eugene A. Ludwig, Comptroller of the Currency, before Twelve State Independent Bankers Associations, on community banking, Washington, DC, June 16, 1994

Anyone reviewing the history of the Office of the Comptroller must be struck by the number of past Comptrollers who were, themselves, community bankers: J.F.T. O'Connor, who spent part of the 1920s as a banker serving the community of Grand Forks, North Dakota, before he came to Washington to serve in the Roosevelt Administration. John Jay Knox, who headed community banks in New York and Minnesota. Henry W. Cannon, who was cashier of the Lumberman's National Bank of Stillwater, Minnesota. Edward Lacey, who was president of the First National Bank of Charlotte, Michigan. William Ridgely, who was vice president of the Ridgely National Bank of Springfield, Illinois. Joseph McIntosh, who headed banks in Nebraska and Illinois. The list goes on.

The representation of community bankers among past Comptrollers says something about the importance of community banking in America. I am not a community banker, but, even so, from the day I took office, the future of community banking in America numbered among my major concerns. The Clinton Administration and the Office of the Comptroller want community banks to continue to be sources of strength for small businesses, engines of growth for our economy and solid building blocks for our communities.

At the Office of the Comptroller, we know that to foster community banking we must recognize that community banks are different from the rest of the banking industry. For one thing, community bankers offer a high level of personal service to the customer. You cannot operate as a bureaucracy and survive. For another, community banks are lean operations; you do not have a lot of institutional fat to absorb costs. Further, most community banks have in common a risk profile characterized by stability. For those reasons, and others, we have sought opportunities to address your differences within our policies. In our current effort to reform the administration of the Community Reinvestment Act, for example, we are trying to find a way to apply streamlined examination procedures to small banks that are serving the needs of their communities.

Four months ago, at the Independent Bankers Association of America convention in Orlando, I discussed how I wanted to address your differences so that those of you with national charters could concentrate on doing what you do best: make loans, advise customers, and build communities.

And I announced that the Office of the Comptroller had under consideration streamlined examinations for well-managed, strong, traditional community banks — examinations that would focus on a community bank's performance. I also announced that, if we found that performance met sufficiently high standards, we would go no further in the examination process.

Today I want to tell you that we have completed testing procedures for these examinations. We have refined those procedures in response to our test findings. And we will send these procedures to our examiners at the end of this month. We will intensively train our examiners under the new procedures for 90 days. And the procedures will go into effect on October 1, right on schedule.

Loan review remains the focus of our examinations. Under the new procedures, if we see that management has achieved consistent performance, we will recognize that management is effective. If our loan review shows that loan quality is good, we will not require documentation of the policies and procedures that led to those results, as we do now. Needless to say, if our examiners find any cause for concern in their reviews of noncomplex banks, we will delve deeper. By and large, though, most noncomplex banks have performed well consistently.

I am sure that you are now asking yourselves: What will determine whether I am eligible for the new procedures?

Though the new procedures will be applied only to institutions with less than $1 billion in assets, the answer is not size — the answer is an institution's risk profile. Every community bank will be categorized into one of two groups, complex or noncomplex. To qualify as a noncomplex community bank, and therefore eligible to be examined under the streamlined procedures, a bank must pass four screens:

(1) It must have a composite rating of 1 or 2 under the Uniform Interagency Bank Rating System and operate under stable conditions. By stable conditions we mean qualities such as stable bank management and ownership and no significant change in operations since the last examination.

(2) It must have management that is effective and responsive in addressing risks and conditions facing the institution.

(3) It must have a record of consistent and strong financial performance.

(4) It must offer primarily traditional products, with only a limited range of nontraditional products.

Categorizing a community bank as complex, which means that it will continue to be examined as it is currently examined, also reflects our focus on an institution's risk profile. A bank will be categorized as complex — and thus not eligible for the streamlined examinations — if it has a composite rating of 3 or worse, or has unsatisfactory management, or is a 1- or a 2-rated bank facing unstable conditions, such as a downturn in the local economy. Newly chartered banks and banks that offer a number of non-traditional products that may have a potential adverse impact on the balance sheet will also be ineligible for the new examination procedures. Complex community banks require more sophisticated policies, systems and internal controls.

To give you a rough idea of what this means to the industry, we expect that the majority of national banks with assets of less than $100 million will be designated noncomplex, and about half of the banks with assets of between $100 million to $250 million will be designated noncomplex. Some banks with assets of $250 million to $1 billion will also qualify.

We will also recognize that some community banks will have a traditional risk profile with the exception of offering a limited number of products that require more detailed examination. When this is the case, we will try to be flexible by categorizing them as noncomplex banks, but addressing their particular products through additional examination procedures — for example, a review of nondeposit investment products.

We will need feedback from those of you who will qualify for streamlined examinations. At the end of every streamlined examination, the CEO will be given a one-page questionnaire to complete. Some of the questions are: "Did the recently completed examination reduce the regulatory burden on your bank?" "Was the time devoted to preparation of requested materials reduced?" "Were the examiners more focused in their approach and did they reduce burdensome requests for corrective action?" All you will have to do is check "yes" or "no." If you would like to offer comments that might assist us in evaluating the new examination procedures, we would love to have them.

I do not believe that the time and effort it will take you to fill out this questionnaire is too much to ask or that any of you will complain about the regulatory burden of doing so. I could be wrong about that— but I will take the chance.

These streamlined examination procedures are only a beginning in our reengineering of the regulatory/supervisory process for national banks. This effort is an installment payment on the promise of the Clinton administration to keep the American economy growing.

At the Office of the Comptroller, we will be continually making improvements in the system — improvements for banking in general and for community banking in particular.

In recent years we relearned, and a hard and expensive lesson it was, that for many Americans, the community bank is not simply a convenience — it is a necessity. In a way that few other business people can say — and mean — you make a real difference in people's lives. In thousands of communities across the country, you are the difference between people being able to move ahead — or having to move out. To tens of thousands of business entrepreneurs who live in those communities, you make the difference between a daydream and the American dream. You have an important job to do. And I promise you this: the Office of the Comptroller will continue to search for ways to lighten the regulatory burden on you to help you do that job well.

Interpretations—April 1 to June 30, 1994

643—April 1994

Mr. Carl Howard, Esq.
Associate General Counsel
Citibank, N.A.
425 Park Avenue
New York, New York 10043

Re: International Equity Investments, Inc. and Citicorp Equity Investments S.A.

Dear Mr. Howard:

This is in response to your letter of June 12, 1992, and earlier communications between Citibank, N.A. ("Citibank" or "the Bank") and the Office of the Comptroller of the Currency ("OCC") concerning Citibank's proposal to continue to engage in debt/equity swaps using its remaining Argentine public sector debt instruments and then to divest of its portfolio of Argentine equities held under its authority to acquire assets in satisfaction of debts previously contracted ("DPC" or "DPC authority"). This proposal would be accomplished through International Equity Investments, Inc. ("IEII" or "the Subsidiary"), an existing wholly-owned subsidiary of Citibank, and IEII's wholly-owned subsidiary, Citicorp Equity Investments S.A. ("CEI"). The proposal would involve the reduction of Citibank's interest in CEI over time through the issuance by CEI of stock to third parties as well as the sale by Citibank of CEI stock held by it. Subject to the representations, understandings, and conditions contained in your letter and set out below, the OCC agrees that Citibank's proposal is a legally permissible exercise of national banks' DPC authority and approves the proposed divestiture of the Subsidiary's ownership of CEI in the manner described.

I. The Bank's Proposal

A. Background

Citibank is a major lender to borrowers in Argentina and other Latin American countries. The Bank has been exploring and implementing a number of approaches designed to reduce its exposure and minimize its losses on such cross-border loans. Among these loans, the Bank has a portfolio of certain rescheduled loans to Argentine public sector companies guaranteed by the Republic of Argentina ("Argentine Debt Instruments" or "ADIs"). It is the Bank's view that it can significantly enhance the level of recovery of principal on its outstanding ADIs and/or the pace of that recovery by means of debt/equity swaps of ADIs held by the Bank for shares of Argentine companies made available through debt/equity swap programs of the Argentine Government.

The Bank has previously engaged in several such debt/equity swap transactions involving ADIs and currently holds equity interests in three Argentine companies acquired under the Bank's authority to acquire assets in satisfaction of debts previously contracted ("DPC"). The three companies are: Celulosa Argentina S.A. ("Celulosa"), a pulp and paper company; Celulosa Puerto Piray S.A. ("CPP"), another pulp and paper company; and Telefonica Argentina S.A. ("TASA"), a telephone company. The Bank holds these equity interests in Argentina through Citicorp Equity Investments S.A. ("CEI"), an Argentine corporation and a second-tier subsidiary of the Bank. CEI engages in no other business and simply serves to hold the Bank's equity interests in Argentine companies acquired DPC.

After the previous debt/equity swaps, the Bank continues to hold ADIs of approximately U.S. $____ (face value, principal and interest). The Bank believes that its recovery on these ADIs would be significantly enhanced by debt/equity swaps. Accordingly, the Bank has been exploring opportunities for debt/equity swaps involving its remaining ADIs. The Argentine Government has a high level of interest and commitment to the successful privatizations of public sector companies and has announced its intention to privatize various state-owned companies. Based on statements by the Government of Argentina and the privatization experience to date, it is anticipated that, while some privatizations may be done on an all-ADI basis, the Argentine Government will continue to require a cash component, in addition to ADIs, as part of the purchase price of many assets to be privatized and that certain privatizations will be done on an all-cash basis. The Bank hopes to engage in additional debt/equity swap transactions to convert its remaining ADIs.

In addition, the Bank also has been exploring methods by which it could improve the value and marketability of its existing DPC equity interests held in CEI and of any additional DPC assets acquired in further debt/equity swaps involving its remaining ADIs. By doing so, the Bank would enhance its ability to divest these DPC assets and recover all or part of its original loan exposure on its ADIs.

The Bank has determined that the most effective way to accomplish these goals (i.e., converting its remaining ADIs into DPC equity interests and then selling its DPC assets) is, in essence, to treat these Argentine DPC holdings collectively under CEI, rather than trying to arrange each debt/equity swap separately and then trying to dispose of each separate DPC equity holding individually. The Bank proposes to conduct a series of related transactions involving CEI that are designed to:

(1) facilitate the Bank's continued conversion of its remaining approximately U.S. $____ of ADIs (principal and interest) into equity DPC; (2) maximize the value of present and future DPC equity holdings; (3) facilitate the divestiture of the DPC properties; and (4) increase the Bank's capital.

B. Transaction Structure

The Bank proposes to accomplish these objectives through the following transactions:

1. CEI will continue to hold the existing Argentine DPC equity interest (CASA, CPP, and TASA).
2. The Bank will contribute its remaining ADIs to CEI which will thereafter exchange such ADIs in debt/equity swaps for Argentine assets being privatized by the Argentine Government.
3. CEI will raise cash through the issuance of new stock to new investors on a private and/or public basis in the Argentine market. The Bank will not be a cash investor; its capital contribution is limited to its ADIs and the existing DPC assets in CEI. In order to attract the new investors to CEI who will provide the cash component, it is necessary that CEI be able to make some investments using only cash, in addition to investments using all ADIs or cash and ADIs.
4. CEI will acquire additional investments through debt/equity swap transactions with the Argentine Government using the Argentine debt contributed by the Bank for this purpose and, in cases in which the Argentine Government requires a cash component, using cash raised by the issuance by CEI of shares discussed above, retained earnings, or future equity or debt issuances by CEI, if needed.
5. The Bank initially will continue as the manager and investment advisor for CEI.
6. The Bank may lend and have other banking relationships with companies in which CEI invests. Any such loans or other banking relationships will be on substantially the same terms as those prevailing at the same time for comparable transactions between the Bank and non-affiliated persons and will be approved by a separate part of the banking organization.
7. The Bank will divest its interest in the Argentine DPC assets through the public or private sale of the Bank's shares in CEI.

By June 30, 1992, the Bank will contribute its remaining ADIs to CEI and will sell privately or publicly shares of CEI held by it such that its ownership in CEI is reduced to approximately 90%. Thereafter, by year-end 1992, CEI will make a private and/or public issuance of stock in the Argentine market, and the Bank will sell at least an additional 14% of CEI on a public or private basis, with the result that Citibank's interest in CEI will be reduced to 52%. (The Bank may sell more than 14% to the extent needed to reduce the Bank's overall interest to 52%, taking into consideration the amount of new stock issued by CEI by year-end 1992.) The order of these transactions may vary depending on negotiations with potential investors.

These transactions in CEI stock will result in income to the Bank and an increase of Tier I capital from the income generated and the minority interest created. The initial sale by the Bank of its 10% interest in CEI is expected to produce income of and to increase Tier I capital by. The exact amount of such income and capital increase, as well as the impact of the transactions to be effected later this year, will depend on the price ultimately obtained for shares of CEI.

Citibank will continue to sell additional shares of CEI held by it so that it further reduces its interest in CEI to no more than 19.9% of the voting shares and 40% of the total equity by year-end 1997, at which time CEI will be managed by a third party. By (or possibly before that date), any shares of CEI still held by Citibank will be transferred to a Citibank affiliate and will be held pursuant to the portfolio investment provisions of Regulation K.

C. Understandings and Conditions

Citibank believes that the proposed CEI transaction is the most effective way, in the circumstances, for Citibank to recover the greatest amount of its original loan exposure on the ADIs and Citibank intends to use its participation in CEI to maximize its reduction of ADIs. In this regard, Citibank intends for CEI to engage in transactions that use ADIs to the maximum extent feasible. However, some transactions by CEI may have a significant cash component, and as discussed above, CEI must retain the capability to do some transactions that may be all cash. Nevertheless, Citibank undertakes that CEI will engage mainly in transactions that use ADIs, so as to reduce Citibank's ADI exposure, and to engage in all-cash deals or principally-cash deals only secondarily and only to a limited extent in furtherance of the overall goal of reducing ADI exposure.[1]

[1]For purposes of this discussion the following definitions apply: "All-cash deals" means transactions in which cash is the only component and there are no ADIs. "Principally-cash deals" means transactions in which the cash component exceeds 50% and the face value of the ADI component is less than 50% "ADI-deals" means transactions in which the face value of the ADI component equals or exceeds 50%.

Citibank further agrees that its investment in CI and CIE's activities will be subject to the conditions set forth below:

1. The total amount of all-cash deals in the aggregate will be limited to 5 percent of the aggregate face value of the ADIs converted already, those ADIs to be contributed, and the cash raised by CEI in its offerings in 1992. Citibank expects that CEI will raise in the range of ____ so that the total amount of CEI's assets for this purpose will be approximately ___ of which 5 percent is . Citibank will provide the OCC with final figures.

2. Citibank shall notify and consult with the OCC prior to CEI's entering into any all-cash deal above $25 million or any principally-cash deal above $25 million in which the cash component exceeds 75 percent of the total; and Citibank shall not proceed with the transaction if the OCC objects.

3. Citibank shall provide regular (quarterly) notification and description to the OCC of all transactions, including all-cash, principally-cash, and ADI-deals, and of the resulting composition of CEI's holdings.

4. For any all-cash deals, whether above or below $25 million, and for any principally-cash deal, Citibank will be required to show what efforts it has made to do ADI-deals and what proportion of existing deals were ADI-deals, principally-cash deals, or all-cash deals; to demonstrate how the all-cash deal or principally-cash deal enhances the value of CEI; and to demonstrate why the proposed all-cash deal or principally-cash deal is necessary (including, where possible, a relationship between the all-cash deal or principally-cash deal and other ADI-deals) to assist Citibank overall in reducing its ADIs, in recovering the greatest amount of its original loan exposure, and in exiting from CEI.

   In cases requiring prior consultation with the OCC, these factors will be used in evaluating the proposed transaction. In cases not requiring prior consultation, documentation of these factors will be used during examinations to assess Citibank's compliance with DPC requirements.

5. All transactions are limited to entities located in Argentina.

6. No Citibank cash will be used as part of the purchase price in any of CEI's transactions. Citibank shall not purchase additional ADIs to do more investments in the CEI vehicle, but shall use only its existing ADIs.

7. Any all-cash investments will be limited to 19.9 percent of the voting interest, and 40 percent of the total equity, of the company invested in.

8. Citibank will sell additional shares of CEI and reduce its holding to 52 percent by December 31, 1992. Thereafter, Citibank shall advise the OCC of its efforts to divest it remaining CEI shares.

9. Citibank will sell additional shares of CEI and reduce its holding to a level no greater than 19.9 percent of the voting interest and 40 percent of the total equity by December 31, 1997.

10. Citibank will no longer hold any CEI shares under DPC authority by the end of the DPC holding period, computed to have begun on ___, at the time of Citibank's first acquisition of DPC assets in CEI (*i.e.*, after extension, the DPC holding period will end on ___). However, a Citibank affiliate may hold CEI shares after (or before) ___, under the portfolio investment authority of Regulation K.

II. Discussion

Citibank asks the OCC to confirm Citibank's position that the activities contemplated in the proposal are consistent with the DPC powers of a national bank and to approve the proposed use of the Subsidiary in divesting of CEI.

A. Background: DPC Authority

The authority of national banks to acquire and hold equity securities in order to improve the prospects for recovery on loans that are in default, are nonperforming, or otherwise have a documented history of poor performance has long been established. This authority has been recognized by the courts. *See, e.g., First National Bank of Charlotte v. National Exchange Bank of Baltimore*, 92 U.S. 122, 127 (1875) ("In the honest exercise of the power to compromise a doubtful debt owing to a bank, it can hardly be doubted that stock may be accepted in payment and satisfaction."); *Atherton v. Anderson*, 86 F.2d 518, 525 (6th Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937) ("It has generally

been thought, however, and we think the view is nowhere seriously disputed, that a bank has implied power when faced with a loss growing out of a legitimate banking transaction to acquire stocks or other property when it is honestly believed at the time that under more favorable circumstances a loss which would otherwise accrue might be averted or diminished."). The OCC, other regulators, and general banking practice also recognize this authority. *See, e.g.,* 12 CFR 1.11 ("restrictions and limitations [on holding investment securities] do not apply to securities. . . acquired in good faith by way of compromise of a doubtful claim or to avoid a loss in connection with a debt previously contracted").

Moreover, in a DPC transaction, national banks may acquire assets that they are not otherwise authorized to purchase. With respect to real estate, 12 U.S.C. 29 expressly provides authority for national banks to acquire real estate DPC. The incidental powers clause of 12 U.S.C. 24(Seventh) is the source of authority for national banks to take other assets, including stock, in a workout arrangement as satisfaction for debts previously contracted. Drawing on the analogy to 12 U.S.C. 29, the OCC has generally imposed certain restrictions on the holding of the DPC assets. These include requirements that national banks make a good faith effort to dispose of their DPC assets as soon as commercially reasonable and that they dispose of their DPC assets within time limits similar to those in 12 U.S.C. 29.

In addition, the OCC previously has recognized that foreign public sector debt may be eligible for DPC treatment when, in the opinion of bank management, the acquisition of property in satisfaction of the debt is necessary to prevent anticipated loss. In this context, the rescheduled or nonperforming condition of the debt is viewed as sufficient evidence of adverse change in the financial capacity of the borrower to permit a bank to exercise its DPC authority. A series of OCC letters has addressed various proposals from banks proposing to exchange qualifying debt for equity in companies in the debtor country under various countries' debt/equity swap programs. *See* OCC Interpretive Letter No. 511 (June 20, 1990), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 83,213; OCC Interpretive Letter No. 502 (April 6, 1990), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 83,097; OCC No-Objection Letter No. 89-1 (January 25, 1989), *reprinted in* Fed. Banking L. Rep. (CCH), ¶ 83,009; OCC No-Objection Letter No. 88-7 (May 20, 1988), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 84,047; Letter from J. Michael Shepherd, Senior Deputy Comptroller for Corporate and Economic Programs (July 14, 1988) (unpublished) (approval letter for subsidiary needed for structure of proposal in Letter No. 88-7); OCC No-Objection Letter No. 87-10 (November 27, 1987), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 84,039.

Accordingly, the underlying components of the proposal, if done separately, would be within the scope of the OCC's earlier letters. That is, it would not be a significant expansion over the previous letters for Citibank (directly or through CEI) to: (1) continue separately to hold its existing DPC equity interests in Argentina, (2) hold its remaining ADIs; (3) exchange the remaining ADIs, and where necessary cash, in debt/equity swaps for additional DPC equity interests in Argentina; (4) hold such additional DPC equity interest; and (5) dispose of its existing and additional DPC equity interests separately company-by-company.

However, the Bank proposes to handle these DPC activities collectively through CEI, not separately. That change gives rise to several new issues with respect to national banks' DPC authority.

B. Application to Bank's Proposal

Citibank proposes to use CEI as a vehicle (1) to hold the Bank's existing DPC holdings in Argentina, (2) to acquire and hold additional DPC holdings in Argentina which CEI will obtain by exchanging the Bank's remaining ADIs and where necessary cash, (3) to raise any needed cash from investors other than the Bank, and (4) to accomplish the divestiture of the Bank's Argentine DPC holdings by selling the Bank's shares in CEI. The Bank believes that use of the CEI vehicle in this manner is a more effective way of disposing of the Bank's DPC holdings in Argentina than if the Bank were to acquire, hold, and attempt to divest of each DPC investment separately. The Bank also believes that it will substantially increase the likelihood that Citibank will recover its original loan amounts, the face amount of its ADIs plus accrued interest. The Bank expects these results because there is substantially more investor interest in a diversified pool of investments, and that greater interest will effectively enhance the value of, and facilitate the Bank's disposition of, the DPC investments compared to what would occur if the investments were considered separately.

The Bank also believes that access to third-party investor capital and borrowings by CEI will allow Citibank to convert its remaining ADIs in Argentine governmental privatization programs without the need of providing any additional cash itself. In order to attract outside investors — both those investors who will buy shares from CEI, thereby providing the cash component for debt/equity swaps, and those investors who will buy CEI shares from Citibank, thereby accomplishing Citibank's divestiture of its DPC assets — the Bank believes CEI needs the ability to make a limited amount of all-cash investments in Argentina (e.g., privatization transactions in which the Argentine Government requires all-cash terms and does not include an ADI

component). This is to provide flexibility to invest CEI funds in the event that suitable transactions involving ADIs are not available. The funds for any such all-cash deals would come from CEI sources other than the Bank. Such all-cash deals would not in themselves be DPC holdings with respect to the Bank because they do not involve ADIs.

This proposal raises three new issues with respect to national banks' DPC authority: (1) whether national banks may pool a collection of DPC assets under a "DPC holding subsidiary," (2) whether a national bank may divest of such DPC assets by selling its shares in the "DPC holding subsidiary" over time, and (3) whether a limited amount of non-DPC assets may be included in the pool of assets to improve marketability and enhance the bank's recovery on its original loan amount.

With respect to the first issue, the OCC finds nothing objectionable in a national bank pooling a group of DPC assets into and under a bank subsidiary formed to hold, manage, and dispose of the assets. Such an arrangement can be administratively useful for the bank and may serve various business and legal purposes related to holding, managing, and transferring the DPC properties. Finally, by providing a separate collective vehicle that can itself be sold, it gives a bank an additional technique for disposing of its DPC assets. These purposes are fully consistent with DPC authority. Where a bank can show reasonable business reasons for handling DPC assets in this manner to maximize recovery on its loans, then reliance on DPC authority is justified.

With respect to the second issue, the OCC believes a national bank that has established a "DPC holding subsidiary" to hold and dispose of a group of DPC assets has the authority to sell that subsidiary over time, by selling its shares in the subsidiary. The bank is not required to sell the entire subsidiary corporation at once. The bank must show valid business reasons for divesting the subsidiary over time rather than more immediately, and the bank's total divestiture period must not exceed the holding period for DPC property. In essence, the OCC believes that when the sole function of a subsidiary is to hold, and be the vehicle for disposition of, DPC assets, then it is more appropriate to treat the subsidiary (and its shares) as DPC property of the bank, subject to the DPC holding and divestiture rules, than to treat the subsidiary as if it were intended to be a regular on-going operating subsidiary and subject to the 80 percent requirement of 12 CFR 5.34(c).

Although the 80 percent ownership requirement of section 5.34 does not apply, national banks still require prior OCC approval to establish a new subsidiary, or to use an existing subsidiary, to become a holding and disposition vehicle for DPC assets in a manner similar to Citibank's proposal. Any bank making a request regarding such a subsidiary should (1) show the business reasons justifying use of such a corporate vehicle to maximize recovery on the DPC assets, (2) explain why other means of handling the DPC assets are not available or not effective, and (3) provide a plan for divestiture of the DPC subsidiary within the DPC holding periods.

With respect to the third issue, the OCC believes that a limited amount of non-DPC investments (that are otherwise not bank permissible) may be included in a DPC pool when that is shown to be necessary to enhancing the bank's recovery of its original loan amount by facilitating the success of the pool vehicle and the bank's divestiture, and when the non-DPC assets are clearly incidental and subordinate to the overall goal of the bank's divestiture of the DPC assets and recovery on its loan amounts. Although such non-DPC assets would not be permissible holdings for a national bank by themselves, their inclusion in the greater pool of DPC assets can be a permissible exercise of DPC authority if the non-DPC assets are needed for the bank to achieve the best recovery.

In this respect, the inclusion of non-DPC assets in a DPC pool vehicle is (for DPC pool vehicles) the parallel to the established practice of spending additional funds on an individual DPC asset to enhance the bank's recovery. Such funds may be spent to improve or complete an asset to bring it to a salable condition, to buy out other creditors on the asset, or even to buy an adjacent property (such as a parking lot or an easement) to protect the bank's interest in its DPC property. In such cases, the additional funds are being spent on something that is not a bank permissible investment in itself but becomes a permissible exercise of DPC authority because of the connection of the new investment to the bank's recovery on its DPC asset. Of course, such non-DPC investments (whether additional assets in a pool or additional expenditures on an asset) are limited to what is required by business necessity for the bank to recover on its original loan and cannot be used merely for speculative purposes.

There are also analogies outside the DPC area for the concept that certain activities that are not bank permissible in themselves may be allowed when they have become an integral part of a larger whole and the whole is bank permissible. One example would be the provisions of the OCC's Interpretive Ruling on personal property leasing before the Competitive Equality Banking Act of 1987. *See* former Interpretive Ruling 7.3400, 12 CFR 7.3400, now codified at 12 CFR 23, Subpart C. That ruling was based on the authority to offer lease transactions that were the functional equivalent of an

extension of credit. Nevertheless, it authorized banks to retain a residual value (in effect an ownership interest in the leased property) of up to 25 percent. Since national banks, before CEBA, did not otherwise have the authority to own the leased property and there is no analog for residual value in a lending transaction, the authority for permitting such residual value was that it was permissible as an incidental part of the overall lease.

Another example would be the inclusion of general purpose computer hardware in the provision of financial data processing services. The sale of general purpose computer hardware is not, in itself, an activity that is permissible for national banks or bank holding companies. Yet both the Federal Reserve Board (for bank holding companies) and the OCC (for national banks and their operating subsidiaries) have allowed the sale of such hardware when it is an incidental part of the provision of a package of otherwise permissible financial data processing services. *See* 12 CFR 225.25(b)(7) (Federal Reserve Board Regulation, allowing impermissible hardware to constitute up to 30% of the cost of a package of permissible services); OCC Interpretive Letter No. 345 (July 9, 1985), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,515 (sale of impermissible hardware as part of a permissible services package is permissible when inclusion of hardware is necessary, convenient, or useful to providing the permitted services in the package taken as a whole, and the hardware is subordinate within the total package). The Federal Reserve Board's ruling and reasoning were upheld in court. *See Association of Data Processing Service Organizations, Inc. v. Board of Governors of the Federal Reserve System,* 745 F.2d 677, 692-95 (D.C. Cir. 1984).

Finally, the fact that in Citibank's proposal the funds for the non-DPC assets do not come from Citibank but from the other investors in CEI provides a basis for an alternative approach. If Citibank were providing the funds for the non-DPC assets in the CEI DPC pool, as well as managing CEI, then all of the activities in CEI should be attributed to Citibank and analyzed for bank permissibility. In that case, the inclusion *by a national bank* of otherwise impermissible non-DPC assets would have to depend on the rationale that it is incidental to the disposition of the overall DPC pool (discussed above). But since the funds for non-DPC assets are being generated by CEI from other sources, then it may be more appropriate to view Citibank's role as an exchange of DPC assets (the various Argentine DPC holdings being exchanged for shares in CEI to be held by Citibank DPC) rather than attributing CEI's activities to Citibank.

In several earlier letters, the OCC has allowed national banks to exchange DPC assets already held by them for another asset to be held DPC. Typically, these situations involve the exchange of DPC real estate for a different piece of real estate or, more relevant here, for stock in a real estate company or shares in a fund set up to acquire, manage, and dispose of real estate from many sources. *See, e.g.,* Letter from Donald G. Coonley, Chief National Bank Examiner (July 2, 1990) (unpublished) (exchange of OREO for limited partnership interests in real estate limited partnership); Letter from Robert J. Herrmann, Senior Deputy Comptroller for Bank Supervision Policy (February 3, 1989) (unpublished) (same); OCC Interpretive Letter No. 395 (August 24, 1987), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,619 (exchange of OREO for preferred stock in a publicly traded real estate company).

In these DPC exchanges, the OCC viewed the shares being received in the exchange as DPC property, and the bank's continued holding of the shares was subject to DPC limitations. In particular, the banks were required to have plans for how they would divest the exchanged DPC assets within the appropriate holding period. The OCC did not view the underlying company or limited partnership as subject to DPC or other banking law limits. The OCC expressed concerns about the activities of the partnership only when the planned method for divestiture of the banks' DPC partnership interests was liquidation of the real estate assets and distribution of cash to the partners, rather than the bank selling their partnership interests to other investors in the market. If Citibank's proposal is viewed as an instance of a DPC exchange, then Citibank would treat its shares in CEI as its DPC property subject to DPC restrictions, and the other activities that CEI engages in would not be relevant, just as a bank may hold stock DPC in any type of company.[2]

Based upon the foregoing, the OCC believes Citibank's proposal is a legally permissible exercise of its DPC authority. Citibank has articulated the reasons why it believes the pooling of its Argentine DPC assets into a corporate vehicle and then divesting its ownership of

[2]The Bank's proposal is more complex than a typical example of a DPC exchange, mainly because remaining ADIs are involved and Citibank initially owns most of CEI. But one can consider simpler versions of the proposal in which the application of the DPC exchange approach would be more obvious. For example, if Citibank had already converted its remaining ADIs into a number of Argentine equities held DPC and simply exchanged those DPC assets for shares of CEI while other investors purchased 10-25% of shares from CEI for cash, then the proposal would be closer to the exchanges in the earlier letters. Or if, instead of placing its Argentine DPC assets in CEI, Citibank had exchanged them for shares of an unrelated and much larger "Argentine Investment Fund," then the proposal would be quite similar to the DPC real estate exchanges in the prior OCC letters. The fact that the Citibank proposal has additional complications should not obscure the fact that it is fundamentally an exchange of DPC assets (the Argentine debt/equity swap equities) into another DPC asset (CEI shares).

the shares in the corporate vehicle is a more effective business method in the circumstances for handling these DPC assets and recovering the Bank's original loan amounts. In particular, the context of seeking recovery on rescheduled foreign public sector debt and disposing of DPC assets in a foreign country can reduce the availability of other options and place unique limitations on what a bank may do. In addition, the various understandings and conditions (set forth earlier) which Citibank has included in its proposal — such as the commitment to a specific divestiture schedule, the undertaking to engage mainly in transaction that use ADIs, the fact that no new Citibank funds are invested in CEI, and the overall 5 percent limitation on non-DPC assets — help to support a determination that the purpose of the proposed transaction is DPC recovery on Citibank's original loan amount and not speculation or any other impermissible purpose.

III. Conclusion

Accordingly, based on the Bank's description of and representations regarding the proposed transaction and based on the Bank's commitment and adherence to the understandings and conditions set forth earlier, the OCC has determined that the proposed transaction is legally permissible for the Bank and hereby approves the proposed use of the Bank's Subsidiary in carrying out the proposal. Please be advised that all conditions of this approval shall be deemed to be "condition[s] imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818. This approval is effective on June 30, 1992.

Frank Maguire
Acting Senior Deputy Comptroller
Corporate Policy and Economic Analysis

* * *

644—May 1994

H. Gary Pannell, District Counsel
Southeastern District
Marquis One Tower
245 Peachtree Center Ave., NE
Atlanta, GA 30303-1223

Dear Mr. Pannell:

This is in response to your request for an opinion on the applicability of certain provisions of the Georgia Residential Mortgage Act, O.C.G.A. 7-1-1000, *et. seq*, ("the Act"), to national banks operating in Georgia. For the reasons discussed below, national banks cannot be required to register with the Georgia Department of Banking and Finance ("DBF"), nor can they be compelled to pay a $6.50 fee to the DBF for every mortgage loan they close in Georgia.

I. The Georgia Residential Mortgage Act

The Act purports to apply to all persons who transact business directly or indirectly as mortgage brokers or mortgage lenders in Georgia. A mortgage broker is defined as any person who directly or indirectly solicits, processes, places or negotiates mortgage loans for others; a mortgage lender is any person who, directly or indirectly, makes, originates, or purchases mortgage loans or who services mortgage loans. The Act's provisions extend to any mortgage lender or mortgage broker, even those located outside Georgia, if the property securing the mortgage loan is located in the state.

The Act contains registering and licensing requirements for all mortgage brokers and lenders unless exempted. Banks, savings institutions, building and loan associations and credit unions chartered under federal or state law that have offices in Georgia are exempt from the licensing and registration requirements under the Act. O.C.G.A. 7-1-1001(a)(1). However, federally chartered institutions with no business location in the state must register with the DBF if they engage in residential mortgage lending activities in Georgia. O.C.G.A. 7-1-1001(b). In addition, out-of-state banks with a business location in Georgia, such as a representative office or a loan production office, must register with the DBF as a foreign bank. O.C.G.A. 7-1-590. Such institutions must register on forms provided by the DBF and pay an annual registration fee of $800.

All mortgage lenders and brokers, even if exempt from the Act's licensing and registration requirements, must pay a fee of $6.50 per mortgage loan closed in Georgia. Along with this fee, all mortgage lenders and brokers must submit a form to the DBF that contains the name of the institution, its license and registration number (if applicable), and the number of loans closed during the reporting period. The DBF can issue administrative orders to enforce compliance with any provision of the Act. Failure to comply with such an order may result in civil fines of up to $1,000 per day and imprisonment of responsible employees for not more than one year. O.C.G.A. 7-1-1018(c) and -1019.

II. Discussion

A. Federal Preemption

The supremacy clause of the Constitution provides that "[t]his Constitution, and the Laws of the United States

which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const. art. VI, cl. 2. Thus, "[t]he constitution and laws of a state, so far as they are repugnant to the constitution and laws of the United States, are absolutely void." *Cohen v. Virginia,* 19 U.S. (6 Wheat.) 264, 414 (1821) (Marshall, C.J.). However, non-conflicting state and federal authority in a particular area may coexist if Congress has not moved to assert exclusive federal jurisdiction. *See California Coastal Comm'n v. Granite Rock Co.,* 480 U.S. 572 (1987).

There are many occasions when national banks are legitimately bound by state law. Nevertheless, national banks derive their powers and authority under federal law, and they are not subject to state law if it conflicts with some paramount federal law. *Flood v. City Nat'l Bank of Clinton,* 220 Iowa 935, 263 N.W. 321 (1935), *cert. denied,* 298 U.S. 666 (1936). As the Supreme Court explained:

> National banks are instrumentalities of the Federal government created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt by a state to define their duties, or control the conduct of their affairs, is absolutely void, whenever such attempted exercise of authority expressly conflicts with the laws of the United States, and either frustrates the purpose of the national legislation, or impairs the efficiency of these agencies of the Federal government to discharge the duties for the performance of which they were created.

McClellan v. Chipman, 164 U.S. 347, 356-57 (1896).

In my opinion, the registration and fee provisions of the Georgia Residential Mortgage Act are preempted by federal banking law.

B. Registration

The Act exempts most federally chartered banks from its licensing and registration provisions. O.C.G.A. 7-1-1001(b). As noted above, however, out-of-state banks with a business location, such as a loan production office, in Georgia are required to register annually with the DBF; out-of-state federally chartered institutions with no business location in the state must also register with the DBF if they engage in residential lending in Georgia. O.C.G.A. 7-1-590 and 1001(b). Such institutions are required to pay an annual registration fee of $800. O.C.G.A. 80-5-1-.02(c)(3). These requirements are inapplicable to national banks.

Under the Act, "[n]o person required to register under this subsection shall transact business in this state directly or indirectly as a mortgage broker or a mortgage lender unless such person is registered with the department." Thus, the Act attempts to predicate the ability of national banks located outside Georgia to do business in Georgia upon their registration with the DBF. As such, the Act's registration provision amounts to a state licensing requirement. "A license is in the nature of a special privilege, entitling the licensee to do something that he would not otherwise be entitled to do without the license." OCC Interpretive Letter No. 122, Fed. Banking L. Rep. (CCH) ¶ 185,203 (August 1, 1979); *see also* 51 Am. Jur. 2d *Licenses and Permits,* § 1 (1970). The Georgia requirement clearly fits this description because registration is mandatory and failure to comply with the Act is punishable as a misdemeanor, with accompanying fines or imprisonment. O.C.G.A. 7-1-1017(d).

As instrumentalities of the federal government, national banks are not required to obtain state approval for the exercise of the powers granted to them by Congress. *See Bank of America v. Lima,* 103 F. Supp. 916 (D. Mass. 1952) (Exercise of national bank powers is not subject to state approval and states have no authority to require national banks to obtain a license to engage in an activity permitted to them by federal law.) National banks are authorized by federal law to exercise "incidental powers ... necessary to carry on the business of banking ...." 12 U.S.C. 24 (Seventh). The mortgage lending activities that are the subject of the Georgia Act are directly related to a national bank's express authority to lend money secured by personal or real property. Consequently, these federally authorized activities are not subject to the qualification that they must be further authorized by state officials.

C. The Georgia Residential Mortgage Act Per Loan Fee

The Act requires that "[a]ny person who closes mortgage loans. . .regardless of whether said person is required to be licensed or registered. . .shall pay the Department a per loan fee of $6.50 for each mortgage closed by that person on and after January 1, 1994. " 80-5-1-.04. The Act is notably silent on the purpose of this fee. This office has in the past suggested that a fee imposed by a state or municipality may be applicable to national banks if it constitutes a tax instead of a payment to support a licensing system. *See* Letter of Richard V. Fitzgerald (October 22, 1986) ("Fitzgerald letter"). However, the per loan fee at issue does not constitute a permissible state tax.

Under 12 U.S.C. 548, national banks are subject to state taxation to the same extent as state banks:

For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.

12 U.S.C. 548. One factor that distinguishes a licensing fee from a tax is the existence of a licensing scheme that vests the licensing authority with discretion to grant or deny the license based upon an applicant's adherence to certain proscribed rules or standards. Fitzgerald letter at 3. As discussed above, the Act creates such a scheme that purports to apply to at least some national banks.

A second factor that distinguishes a licensing fee from a tax is that the former generally bears a reasonable relationship to the cost of administering a specific regulatory program. *Arends v. Police Pension Fund of Peoria, et al.,* 130 N.E. 2d 517 (Ill. 1955). A tax, on the other hand, is typically paid to the state general fund and used for any state purpose. The per loan fee imposed by the Act is paid directly to the Georgia DBF instead of the state treasury. Clearly, then, the per loan fee is intended to offset the administrative costs associated with the Act. To the extent those costs would largely be associated with the licensing and supervision provisions of the Act, national banks are not required to help defray them.

Even assuming that the licensing and registration fees paid by non-exempt mortgage lenders and brokers cover the costs associated with the administration of those provisions, the per loan fee would still be inapplicable to national banks. In addition to the licensing and registration provisions, the Act contains various other restrictions of the practices of mortgage lenders and brokers. For example, the Act contains disclosure and advertising requirements. O.C.G.A. 80-11-1-.01 and .02. Assuming for the sake of this discussion that such provisions are applicable to national banks, national banks should not have to pay for state enforcement of these laws.

Under 12 U.S.C. 482, the OCC is the exclusive supervisor of national banks and is authorized by Congress to assess fees against national banks to pay for the cost of their supervision. This authority includes examination for compliance with applicable state laws. *Nat'l State Bank, Elizabeth, N.J. v. Long,* 630 F.2d 981 (3d Cir. 1980); *see Conference of Fed. Sav. & Loan Ass'ns v. Stein,* 604 F.2d 1256 (9th Cir.), *aff'd mem.*, 445 U.S. 921 (1979) (federal regulator is the proper authority to enforce state laws applicable to federal thrifts.) "Since this Office examines national banks for compliance with state consumer laws, and the banks pay for this procedure . . . it would be difficult to justify a requirement that national banks pay [similar] fees in support of them" to state regulators. Letter of J.T. Watson, Deputy Comptroller of the Currency (January 7, 1975) (unpublished).

Because the Georgia Residential Mortgage Act Per Loan Fee is not a permissible state tax and is intended to defray the costs of inapplicable licensing requirements or for state enforcement powers that do not extend to national banks, it is preempted by federal law.*

III. Conclusion

Although state laws may embody important state policy, under the supremacy clause the relative importance to a state of its own law is not material when there is a conflict with federal law; any state law that interferes with, or is contrary to federal law, must yield. Therefore, it is my conclusion that the provisions of the Georgia Residential Mortgage Act discussed in this letter are preempted by federal law, with respect to national banks.

Peter Liebesman
Assistant Director
Bank Operations and Assets Division

* * *

645—May 1994

Based on the description set forth in the letter dated December 7, 1993, and telephone conversations with OCC representatives, the Office of the Comptroller of the currency ("OCC") has determined that the bank may proceed with its plans to participate in a limited liability company to originate and service residential real estate mortgage loans.

A. Facts

The LLC would be organized as a limited liability company under state law. The LLC will operate out of the bank's principal offices and will not engage in activities outside of that state. The bank will have an 80 percent

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*This conclusion is consistent with Executive Order 12612, which allows federal preemption of a state law "only when the statute contains an express preemption provision or there is some other firm or palpable evidence compelling the conclusion that the Congress intended preemption of State law, or when the exercise of State authority directly conflicts with the exercise of Federal authority under the Federal statute." The statutes discussed above constitute such firm and palpable evidence of Congressional intent to preempt state law in this area. In addition, the exercise of state authority by the Georgia DBF directly conflicts with the exercise of federal authority over national banks.

voting interest in the LLC and the remaining 20 percent voting interest will be held by a corporation that will provide the personnel and administrative and business services associated with residential real estate lending, including loan solicitation, loan servicing, loan underwriting, loan closing, and property inspections. The LLC will retain servicing rights on loans which it originates and receive loan fees, points and an interest differential to pay for the costs of operation. The LLC will be managed by a Steering Committee comprised of five members, four of whom will be selected by the bank and one of whom will be selected by the corporation.

B. Analysis

It is clear that the proposed activities of the LLC, the origination and servicing of residential real estate loans, are legally permissible under 12 U.S.C. 24 (Seventh) (general ability of national banks to make loans); 12 U.S.C. 371 (ability of national banks to make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate); OCC Interpretive Ruling 7.7379, 12 CFR 7.7379 (ability of national banks to service loans); and the incidental powers clause of 12 U.S.C. 24 (Seventh).

The component of the bank's proposal which is a relatively new concept is that it contemplates the conduct of permissible national bank activities through an LLC. An LLC is an unincorporated business entity that provides its members with limited liability and allows them to participate actively in the entity's management. An LLC is a hybrid entity with characteristics of both a partnership and a corporation: it is treated as a corporation for liability purposes but for Federal tax purposes, it is treated as a partnership. Because there is no uniform or model LLC act, various states have adopted unique statutes authorizing the formation of such entities.

As structured under the operating agreement, the proposed LLC has certain key attributes of corporations, operating subsidiaries, partnerships, and joint ventures that the OCC has permitted banks to participate in — i.e., bank control over the entity and limitation or insulation of the bank's liability for the entity's activities. The OCC has permitted banks to structure their business in a number of different ways provided these criteria are met. The proposed structure is consistent with prior OCC opinions in which the OCC has authorized national banks to participate in partnerships and joint ventures provided that: (1) the partnership or venture is engaged in a bank permissible activity; and (2) the bank is shielded from unlimited liability for the acts of other partners or venturers. *See generally,* OCC Interpretive Letter No. 423, *reprinted in,* Fed. Banking L. Rep. ¶ 85,647 (April 11, 1988) (national bank operating subsidiary authorized to act as managing general partner of a limited partnership); OCC Interpretive Letter No. 289 (May 15, 1984), *reprinted in* [Transfer Binder 1983-1984] Fed. Banking L. Rep. (CCH) ¶ 85,453 (national bank permitted to become a limited partner in a banking-related venture).

In the instant case, it appears that the bank would have commensurate control over the affairs of the LLC and be shielded from unlimited liability. In addition, although the proposed operating agreement does not include a choice of law provision, bank counsel represents that the LLC will not operate outside of the State of , and any contracts, loan documents or approvals would be signed only in The Bank would perform all credit analyses while the LLC would primarily perform brokerage functions and would not book any loans.

C. Conclusion

Based on the above-described analysis, the bank may proceed with its proposed plan to participate in the LLC that will be formed to originate and service residential real estate mortgage loans. This determination is based upon the representations made with respect to the proposed LLC and the understanding that the LLC will be operated within the constraints of all national banking laws, rulings and regulations. Any material difference or deviation from the facts as described above could result in a different conclusion.

Frank Maguire
Senior Deputy Comptroller
Corporate Activities and Policy Analysis

* * *

646—May 1994

Jeffrey R. Jones
Cashier
Vice President and Senior Associate Counsel
The Chase Manhattan Bank (N.A.)
Legal Department
One Lincoln First Square CS-5
Rochester, New York 14643

Dear Mr. Jones:

This responds to your letters indicating that The Chase Manhattan Bank of Connecticut, National Association (the bank) intends to conduct certain asset management activities through one or more operating subsidiaries. For the reasons set out below, the bank may proceed with its proposal, subject to the limitations described at the end of this letter.

The Bank's Proposal

Consolidated Asset Recovery Corporation ("CARC"), a subsidiary of the bank, currently performs asset management services for the Federal Deposit Insurance Corporation ("FDIC"). You have described the services that CARC currently performs for the FDIC as follows:

> These services include, among others, reviewing, classifying, and valuing loan portfolios; marshalling and reviewing legal documentation; developing plans of action for specific assets; processing payments on performing loans; negotiating renewals, extensions, and other restructurings of loans; initiating and overseeing foreclosure, bankruptcy and other legal proceedings; contracting with independent firms for the on-site management of ORE [other real estate owned]; preparing assets for sale or securitization; selling loans and other assets; and preparing reports for review by the client. CARC also conducts (or arranges for and reviews) appraisals and environmental inspections, performs cash flow and asset-review analysis, and leases ORE and other DPC properties.

You propose that the bank would, through one or more subsidiaries, provide these services to the following additional classes of customers:

A. Any third party who acquires assets from the RTC or the FDIC as conservator or receiver, as long as there is a nexus between the RTC or FDIC and the asset manager which assists the RTC or FDIC to recover all or part of their costs.

B. Any bank or savings association under a national bank's authority to provide correspondent services.

C. Affiliates of banks or savings associations under a national bank's authority to provide correspondent banking services.

D. Any third party who acquires assets from a bank, savings association, or an affiliate of a bank or savings association, provided that the assets are of a type that a national bank may own.

On June 15, 1993 the OCC approved asset management services for the classes of customers described in "A" and "B." This letter approves asset management for the customers described in "C" and "D."

The Federal Reserve Board has concluded that a bank holding company may provide services substantially identical to the services you have described for any asset that a bank could have originated, regardless of who in fact originated or owns the assets. *See The Dai-Ichi Kangyo Bank, Ltd.*, 79 Fed. Res. Bull. 131 (1993).

Discussion

Banks have express authority under 12 U.S.C. 24(Seventh) and 371 to make loans. Incidental to this authority, national banks may service loans and, under current OCC interpretations, manage loans and assets acquired through foreclosure on loans or in satisfaction of debts previously contracted ("DPC assets").

Collection and servicing of evidences of debt owned by others has long been a part of the banking business. *See Miller v. King*, 223 U.S. 505, 510 (1912) (national bank may "do those acts and occupy those relations which are usual or necessary in making collections of commercial paper and other evidences of debt" for its customers). Under existing OCC interpretations, a bank may collect delinquent loans on behalf of other lenders,[1] provide billing services for fees owned to doctors, hospitals, and other service providers,[2] and service mortgage loans.[3]

As already mentioned, OCC interpretations have also allowed banks to manage loan and DPC assets for certain types of customers, i.e., financial institutions, the RTC, or subject to certain restrictions, third parties who had acquired the assets from the RTC or FDIC.[4]

These letters approved asset management services only for certain customers because they relied on national banks' traditional practice of providing correspondent services to financial institutions as a source of authority to offer loan and DPC asset management services. But correspondent services is not the only source of banks' authority to engage in DPC asset management.

Like loan servicing, which banks can perform for any customer, asset management is an intrinsic part of banks' lending function and therefore falls within their express power to make loans. Lending includes not only the initial extension of credit but also collecting

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[1] Letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division (August 27, 1985).
[2] Id.
[3] 12 CFR 7 7379
[4] *See* Interpretive Letter No. 539 (January 15, 1991), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,251, OCC Interpretive Letter No. 538 (January 8, 1991), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,249, OCC Interpretive Letter No. 537 (January 8, 1991), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,248

payments, foreclosing on collateral if the debtor defaults, and managing DPC assets.

This is so even where a bank manages loans and DPC assets which have served as collateral on loans originated by another lender. Managing loan-related assets for such customers involves the same activities that a bank performs in its own lending business. The assets under management are the same types of assets that the bank could originate and own itself, and the activities involved in managing them do not differ in kind from the activities involved in the management of the bank's own assets.

Generally, whether an activity or service is incidental to the business of banking depends on the nature of the activity or service, not on the identity of the customer. Just as a bank may lend to anyone and buy, sell, or service loans originated by any entity, so a bank may, directly or through an operating subsidiary, provide asset management services to any customer.

Since national bank's authority to provide asset management services derives from their lending power, banks' ability to provide asset management services is subject to two restrictions: First, a bank may only manage assets that the bank could itself originate or own (that is, loans or DPC assets). Second, with respect to DPC assets, a bank may provide asset management services only for the purpose of, and as an incident to, the prompt disposition of the assets.

Frank Maguire
Senior Deputy Comptroller
for Corporate Activities and Policy Analysis

* * *

647— May 1994

Mr. Robert L. Andersen
First Union Corporation
Legal Department
One First Union Center
Charlotte, North Carolina 28288

Re: First Union National Bank of North Carolina
Operating Subsidiary Notice -
Control Number 93-ML-08-023

Dear Mr. Andersen:

This letter responds to your notification, on behalf of First Union National Bank of North Carolina ("Bank"), of the Bank's intent to establish three wholly-owned operating subsidiaries (collectively, the "Subsidiaries") to acquire the partnership interests of Lieber & Company and the assets and liabilities of Evergreen Asset Management Corporation. Thereafter, the Subsidiaries will engage in investment advisory, brokerage and administrative services to various clients, including the Evergreen family of mutual funds. The Subsidiaries will not act as distributor of the mutual funds.

The Bank's notice was filed with the Office of the Comptroller of the Currency ("OCC") on November 1, 1993, pursuant to 12 CFR 5.34. As provided in section 5.34, the OCC extended its thirty-day review period since the Bank's proposal raised issues which required additional information and time for analysis. The OCC reviewed the Bank's proposal to determine if the proposed activities were legally permissible for national bank operating subsidiaries and to ensure that the proposal was consistent with prudent banking principles and OCC policy. On February 23, 1994, the OCC published a summary of the Bank's proposed acquisition in the Federal Register, affording interested persons an opportunity to submit comments. *See* 59 Fed. Reg. 9017 (1994). The Federal Register notice also requested comments on another pending operating subsidiary notice. The time for filing comments on both notices expired on March 28, 1994, and the OCC has considered all comments received. Six favorable comments were received that specifically mentioned the Bank; these comments focused on the legal precedents for approval, the changing nature of banking, customer protection matters, and maintaining bank competitiveness. Several commenters urged against adopting regulatory conditions that would unfairly burden banks relative to other participants in the mutual funds industry. We also received two comments on the other notice that raised general concerns about bank participation in mutual fund activities.

Based on the information provided in the Bank's letter, accompanying legal memorandum and other written materials, and information provided by commenters, we conclude that the activities proposed by the Bank are permissible for national banks and their operating subsidiaries and are consistent with prior opinions of the OCC. Accordingly, the Bank may implement its proposal pursuant to 12 CFR 5.34 based on the facts as described and in accordance with the submitted materials. This letter also subjects the Bank and the Subsidiaries to all the conditions set forth in this letter.

The Bank's Proposal

The Bank proposes to establish three wholly-owned operating subsidiaries to facilitate the acquisition of two affiliated investment advisory companies: (1) Lieber & Company, a New York general partnership ("Lieber") and (2) Evergreen Asset Management Corp., a Dela-

ware corporation ("EAMC" and, collectively with Lieber, the "Lieber Companies").[1] One operating subsidiary will acquire and retain all the partnership interests in Lieber, except for a *de minimis* interest and another operating subsidiary will hold so that Lieber can continue to qualify as a partnership.[2] The third operating subsidiary will acquire and retain substantially all the operations of EAMC through a purchase of assets and assumption of liabilities or through a merger. The three current partners of Lieber also are the sole shareholders of EAMC.

At present, the Bank proposes to call the Subsidiaries, "Lieber I Corporation," "Lieber II Corporation," and Evergreen Asset Management Corporation. The Subsidiaries will be chartered under the laws of either New York or Delaware and will have offices in Charlotte, North Carolina and Purchase, New York. The Bank represents that no director, officer or employee of the Subsidiaries will serve as a director, officer or employee of any of the Evergreen family of mutual funds.

The subsidiary acquiring Lieber will continue as a registered investment advisor under the Investment advisors Act of 1940, a registered broker-dealer under the Securities Exchange Act of 1934, and a registered investment advisor and broker-dealer in the states where Lieber presently is registered. It also will continue to be a member of the New York Stock Exchange and the American Stock Exchange. EAMC's acquiring subsidiary will continue as a registered investment advisor under the Investment Advisors Act of 1940. Accordingly, the acquiring Subsidiaries will be subject to substantial regulatory requirements under the federal securities laws and the Rules of Fair Practice of the National Association of Securities Dealers, Inc. ("NASD"). As national bank operating subsidiaries, the Subsidiaries also will be subject to examination and supervision by the OCC.

Under the Bank's proposal, the Subsidiaries will engage in the current activities of the Lieber Companies, with certain exceptions. The Lieber Companies predominantly are engaged in providing investment advisory services to their clients as well as certain administrative and brokerage services. Lieber Companies' investment advisory clients fall into three general categories: (1) the Evergreen family of 15 publicly-owned mutual funds ("Evergreen Funds" or "Funds"); (2) several large institutional investors; and (3) a number of high net worth individual investors.

As described in the Bank's letter, the primary client of the Lieber Companies, the Evergreen Funds, has approximately $3.24 billion in assets. The Evergreen Funds family offers various types of funds with different investment objectives, such as equity-oriented funds, money market funds, tax-exempt funds, and a fund investing in United States government securities. Each of the funds is registered as an investment company under the Investment Company Act of 1940 ("1940 Act") and under applicable state laws. Each fund is governed by a board of trustees or directors[3] consisting of not less than four trustees (or directors) subject to 1940 Act requirements concerning independence.[4] Shares of each fund are registered with the Securities and Exchange Commission as required under the Securities Act of 1933. All disclosure and marketing materials relating to the funds, including each fund's prospectus, will comply with applicable requirements under the 1940 Act, the Securities Act of 1933, applicable state securities laws and federal banking laws.

The Subsidiaries will continue to provide investment advisory services to the Evergreen Funds. The sole activity of EAMC is as the direct advisor to the Evergreen Funds; EAMC also has a sub-advisory relationship with Lieber for the funds. While Lieber currently acts as distributor of the funds, the Bank represents that Lieber will resign as distributor at the time the acquisition is consummated. The respective boards of directors of the funds will contract with an independent third party to act as distributor.[5]

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[1]The acquisitions are pursuant to an agreement between First Union Corporation ("Holding Company"), the Bank, Lieber, EAMC and the three principals of the Lieber Companies. The Holding Company will issue shares of its common stock to EAMC and the three principals of Lieber in exchange for the transfer of the assets and liabilities of EAMC and the partnership interests of Lieber. The transaction will be accounted for as a pooling of interests and hence there will be no negative impact on the capital ratios of the Bank.

[2]The Bank represents that it prefers Lieber maintain the present partnership form to eliminate the need to re-execute investment advisory contracts with clients and file time-consuming applications or filing with the New York Stock Exchange and the Securities and Exchange Commission, and further, to provide continuity for current principals and employees of the company. A partnership needs a minimum of two partners.

[3]Certain funds are organized as business trusts thus having a board of trustees; at least one fund is incorporated and exists as a corporation having a board of directors [hereinafter any reference to the "board of directors" also includes those funds with a board of trustees].

[4]Section 10 of the 1940 Act basically provides that at least 40 percent of the directors on the board must be independent, unless certain affiliated relationships exist in which case a majority of the directors must be independent. *See* 15 U.S.C. 80a-10.

[5]Upon consummation of the proposed acquisition, the independent third party will replace Lieber as distributor. The party specifically identified as the distributor will be referred to in the prospectus for Fund shares and will serve as the intermediary between the Funds and purchasers of Fund shares. The distributor will take responsibility for SEC filings and materials submitted to the NASD, although the Subsidiaries may assist in these efforts. The distributor will be responsible for sponsoring new funds, selecting wholesale distributors for sales of Fund shares, for sending, or arranging for the sending, of all confirmations to customers, maintaining and distributing Fund prospectuses, and other duties as required. The distributor will receive a fee for its distribution activities.

Similar to Lieber's activities, the Subsidiaries will provide various administrative services to the Evergreen Funds, which include maintaining and preserving Fund records, computing net asset value and other performance information regarding the Funds, preparing and filing with the SEC and the state securities regulators registration statements and other required materials; preparing and filing tax returns, providing office facilities for the Funds, and coordinating communications and activities between the investment advisor and other service providers. The Bank has provided a list of the administrative services currently performed by Lieber, which is attached to this letter as Appendix A. The Bank represents that these are normal administrative services substantially similar to those recently approved by the Federal Reserve Board in connection with the Mellon Bank Corporation's acquisition of The Boston Company. *See Mellon Bank Corporation,* 79 Fed. Res. Bull. 626 (1993). The Subsidiaries will received a fee for providing the advisory and administrative services consistent with the 1940 Act requirements and general industry practices.

In addition, the Subsidiaries will engage in securities brokerage activities on behalf of their clients, including executing trades for the Evergreen Funds.[6] The Bank represents that the Subsidiaries will not engage in underwriting or dealing. The Subsidiaries also will not sponsor or organize new mutual funds for the Evergreen Funds Family.[7] The compensation received by the Subsidiaries for brokerage services will be consistent with that customarily received by an agent and not that of a principal or dealer.[8]

The Bank has committed that the Subsidiaries will comply with the safeguards provided in the Interagency Statement on Retail Sales of Nondeposit Investment Products, which should reduce any potential safety and soundness concerns, consumer protection issues and conflicts of interest. *See Interagency Statement on Retail Sales of Nondeposit Investment Products* February 15, 1994 (superseding OCC Banking Circular 274, *Retail Nondeposit Investment Sales* (July 19, 1993)) [hereinafter "Interagency Statement"].[9] The Interagency Statement sets forth guidelines which pertain to the sale of mutual fund shares, as well as to related advertising and promotional activities, and provides that banks should market such nondeposit products in a manner that is not misleading or confusing to customers as to the nature of the products or the risks. The application of the Interagency Statement to the Bank and the Subsidiaries is discussed in the subsection of this letter entitled "Application of the Interagency Statement."

We understand that the Bank and the Subsidiaries will conduct their operations in accordance with all applicable laws and regulations. The Bank and the Subsidiaries also will conduct these activities in a prudent manner, consistent with safe and sound banking practices.

Legality of Proposed Activities

Permissible Banking Activities

The National Bank Act provides that national banks shall have the power:

> To exercise. . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.

12 U.S.C. 24(Seventh). The OCC has taken the position that Section 24(Seventh) grants broad powers for banks to engage in the business of banking, including the specifically recited powers and such other incidental powers that are reasonably necessary to perform the business of banking as a whole. *See* Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (extensive analysis concluding that such a broad view is supported by statutory construction, legislative history, case law, general circumstances, and commentators).[10] The courts have used various tests to determine

[6] The Subsidiaries also may provide brokerage services for employees and family members and friends of employees. Any such services will be at arms-length and consistent with general industry practices.

[7] The independent distributor may organize new mutual funds which the Subsidiaries subsequently may advise or administer. The Bank represents that it will not provide seed capital to fund these new mutual funds.

[8] The Bank plans to continue receiving the commissions Lieber currently receives from trades involving the Evergreen Funds, consistent with the limitations of Section 17(e) of the Investment Company Act of 1940 and Regulation § 270.17e-1 concerning transactions between affiliated parties.

[9] We also note that under Section 23A of the Federal Reserve Act, the Bank considers the Funds "affiliates" of the Bank and thus subject to various requirements enacted to protect banks from potential abuses in financial transactions with affiliated companies. *See* 12 U.S.C. 371c and 371c-1.

[10] As one commentator has noted:

> whatever may be the legal rule as to business corporations, or municipal corporations, it seems clear that National Banks are not confined to the powers specified in the National Bank Act and those necessary to carry out those specific powers, and that in the case of National Banks. . . the test is not whether a power is necessarily incident to one of the specific powers

whether banking activities are within the intended scope of Section 24(Seventh) and have found that permissible incidental activities include those that are similar to an express power, relate to an express power, resemble traditional banking functions or constitute financial activities. *See* Letter No. 494, *supra*, at 11-16. The five enumerated powers are examples of banking powers, but not the exclusive list. Many other activities, including those proposed by the Bank, also are inherent parts of the business of banking.[11] We find that the proposed activities for the Subsidiaries are with the scope of banking activities previously considered and found permissible by the OCC, other regulatory agencies and the courts as discussed below.[12]

Investment Advisory Services

The OCC has firmly established that national banks and their subsidiaries have the authority to provide investment advice as part of or incidental to the business of banking. *See e.g.*, Interpretive Letter No. 622 (April 9, 1993), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 83,504; Interpretive Letter No. 367 (August 19, 1986), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,537; *Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (September 23, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,732. Investment advice also is authorized by trust powers provisions in 12 U.S.C. § 92a. The courts have confirmed that bank holding company subsidiaries may act as investment advisors. *See Board of Governors of the Federal Reserve System v. Investment Company Institute,* 450 U.S. 46 (1981) ("ICI"); *Securities Industry Association v. Board of Governors of Federal Reserve System,* 821 F.2d 810 (D.C. Cir. 1987), *cert. denied,* 484, U.S. 1005 (1988) ("NatWest").

Likewise, the OCC has permitted national bank subsidiaries to offer investment advice to customers and simultaneously act as investment advisor to the same mutual fund. *See* Interpretive Letter No. 403 (December 9, 1987), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627. In finding that a bank holding company may serve as investment advisor to a mutual fund, the Supreme Court has recognized that the functions of an investment advisor include management activities:

> The principal activity of an investment advisor is to manage the investment portfolio of its advisee — to invest and reinvest the funds of the client. Banks have engaged in that sort of activity for decades. As executor, trustee, or managing agent of funds committed to its custody, a bank regularly buys and sells securities for its customers.

ICI, 450 U.S. at 55; *see also* OCC Letter from Daniel L. Pearson (January 13, 1993) (approving operating subsidiary to enter into a partnership that will act as a mutual fund manager) [hereinafter the "Pearson Letter"]; OCC Letter from William B. Glidden (January 14, 1988) (national bank investment advisors manage and supervise the investment and reinvestment of cash, securities or other properties comprising the assets of the mutual funds) [hereinafter the "Glidden Letter"].

Brokerage Services

Similarly, numerous OCC and court opinions confirm the long established power of banks and their subsidiaries to perform brokerage services for their customers. *See e.g., Securities Industry Association v. Board of Governors of the Federal Reserve System,* 468 U.S. 207 (1984) ("*Schwab*"); *Securities Industry Association v. Comptroller of the Currency,* 577 F. Supp. 252 (D.D.C. 1983), *aff'd per curiam,* 758 F.2d 739 (D.C. Cir. 1985), *cert. denied,* 474 U.S. 1054 (1986) (brokerage issue); Interpretive Letter No. 494, *supra; In re Security Pacific National Bank* (August 26, 1982), *reprinted in* [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284. The authority of banks to provide brokerage services is within the business of banking as contemplated in 12 U.S.C. 24(Seventh) and is expressly recognized by the language of the Glass-Steagall Act.[13] The OCC has

> granted, but whether it is properly implied from all of the terms used, in light of the general intent and purpose of the statute.

Trimble, *The Implied Power of National Banks to Issue Letter of Credit and Accept Bills,* 58 Yale L.J. 713, 721 (1949).

[11] *See New York State Ass'n of Life Underwriters v. New York State Banking Dept.* 598 N.Y.S. 2d 824 (N.Y. App. Div., 1993), *aff'd,* — N.Y. — (March 30, 1994) (court found similar incidental powers clause of New York banking law permitted banks to expand banking services over time consistent with evolving business practices and customers' needs).

[12] In addition, the OCC has long recognized its authority to establish operating subsidiaries as an inherent part of the business of banking. *See* 31 Fed. Reg. 11459 (Aug. 31, 1966). Operating subsidiaries enable banks to use a different organizational structure to conduct permissible activities. The OCC has provided by regulation that national banks may choose to engage in permissible activities by means of an operating subsidiary. 12 CFR 5.34. The operating subsidiary is subject to OCC examination and supervision and to the same banking laws and regulations as the parent bank unless otherwise provided by statute or regulation. *Id.* Thus the Bank has the authority to establish the Subsidiaries to engage in the proposed activities as long as the activities are permissible.

[13] While Section 16 of the Glass Steagall Act places limitations on certain securities activities of banks, this provision specifically preserved banks' power to broker such securities.

> The business of dealing in securities and stock by the [bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock.

12 U.S.C. 24(Seventh). Further discussion of Section 16 of the Glass-Steagall Act is contained in the subsection of this letter entitled "Glass-Steagall Act."

permitted securities brokerage activities by national bank subsidiaries including the purchase and/or sale, as agent, of shares in mutual funds. *See e.g.*, Interpretive Letter No. 622, *supra*; Interpretive Letter No. 403, *supra*; Interpretive Letter No. 386 (June 19, 1987), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610; Interpretive Letter No. 363 (May 23, 1986), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,533. Further, full-service brokerage, the combination of investment advisory and brokerage services, in the same national bank subsidiary previously has been approved. Interpretive Letter No. 403, *supra;* Interpretive Letter No. 386, *supra*.

An integral part of full-service brokerage is the ability to attract customers by advertising and marketing the services and products available. The Supreme Court in considering a contrary state law found that under its incidental powers a national bank can advertise any service that the bank lawfully offers. *See Franklin National Bank v. New York,* 347 U.S. 373, 377-78 (1954) ("Modern competition for business finds advertising one of the most usual and useful of weapons"). The District of Columbia Circuit has recognized, albeit in a different context, that the selling of securities necessarily involves finding and soliciting buyers:

> [N]o sensible construction of the statute [Section 16 of the Glass Steagall Act] could say that otherwise permissible selling activities cannot involve the solicitation of buyers. The seller's very purpose in engaging a selling agent and paying a commission is to require that agent's superior ability to place the product with buyers. If placement of the product with buyers did not require any solicitation of buyers, no rational business would pay another firm do to what it could without cost to itself: passively wait for orders.

Securities Industry Association v. Board of Governors of the Federal Reserve System, 807 F.2d 1052, 1062 (D.C. Cir. 1986), *cert. denied,* 483 U.S. 1005 (1987) ("Bankers Trust II").

By analogy to the Supreme Court's *Schwab* decision approving brokerage operations, the court noted that banks must advertise to let customers know such services are available:

> It would strain credulity to assert that the circulation of a brochure or the running of an advertisement to publicize the availability of these services would mean that the brokerage services performed are now barred since no longer performed solely upon the order of the customer.

Id. at 1061.[14]

Likewise, the OCC previously has acknowledged the need of national banks to publicize bank's investment advisory, brokerage and administrative services relating to mutual funds. *See* Interpretive Letter No. 622, *supra* (making lobby materials available on services, placing newspaper advertisements, sending statement stuffers and providing other descriptions of the variety of services that are available); Pearson Letter, *supra* (as mentioned in the incoming letter, preparing and distributing explanatory materials concerning the investment portfolios); Glidden Letter, *supra* (furnishing prospectus or sales literature on funds upon request, having advertisements and brochures listing mutual funds available through the bank and the bank's services); *Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (September 23, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,732 (generating and distributing an advisory newsletter with recommendations for the purchase of specific securities); *see also* Interagency Statement, which acknowledges banks advertise and market uninsured investment products to customers and provides for full disclosure.

Based on existing judicial and agency precedent, we find that providing advertising and marketing support relating to mutual funds is an integral part of permissible brokerage and advisory services and thus is part of or incidental to the business of banking under the National Bank Act. The federal securities laws and regulations prohibit materially misleading or inaccurate representations in connection with offers and sales of mutual funds and heavily regulate the content of advertising, marketing materials, and other communications to potential purchasers of mutual fund shares. The federal banking regulators also have adopted an Interagency Statement which sets forth additional provisions governing advertising and marketing by federally insured financial institutions. Further, the Bank has represented that the independent distributor will review and submit advertising materials to the NASD in compliance with applicable requirements. Accordingly, ample regulatory safeguards will apply to any advertising and marketing conducted by the Subsidiaries to ad-

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[14]We also note that nothing in the statutory language of Section 16 of the Glass-Steagall Act suggests that advertising and marketing activities are prohibited. *See* 12 U.S.C. 24(Seventh). Although a recent decision by the Federal Reserve Board approving certain mutual fund-related activities by a nonbanking subsidiary of a bank holding company recited certain representations regarding the limited nature of advertising and marketing in which the applicant proposed to engage, the Board did not find that advertising and marketing are prohibited by the Glass-Steagall Act. *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993).

dress any potential safety and soundness concerns or possible misuse of information.

Administrative Services

In conjunction with investment advisory and brokerage services, the OCC also has permitted national banks and their operating subsidiaries to provide a variety of administrative and shareholder services with respect to the operation of a mutual fund. *See e.g.*, Glidden Letter, *supra* (providing various administrative services and acting as investment advisor to mutual funds); Interpretive Letter No. 386, *supra* (providing recordkeeping, accounting, and other services in connection with 12b-1 and similar plans); Interpretive Letter No. 332 (March 8, 1985), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,502 (recordkeeping, order execution functions, and shareholder information). These administrative functions are incidental to the related provision of investment advisory and brokerage services.

Likewise, the Federal Reserve Board recently has approved a nonbanking subsidiary of a bank holding company to provide various administrative and advisory services to mutual funds. *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993). The Fed approved administrative activities substantially similar to those proposed by the Bank.[15] The Fed reasoned that such administrative activities generally are ministerial or clerical in nature and do not impart impermissible "control" or policy-making authority over the mutual fund. *See id.* at 10-11. As the Board noted, mutual funds are governed by a disinterested board of directors dictated by various independence requirements of the 1940 Act and ultimate control over the funds rests with the board of directors. *Id.* Accordingly, because the administrative services the Bank proposes to provide are substantially similar to those previously approved, we find such services are permissible.

The Glass-Steagall Act

Apart from the authorities discussed above allowing national banks and their operating subsidiaries to engage in the proposed activities as part of or incidental to the business of banking, we also have examined the Bank's proposal under the Glass-Steagall Act ("GSA" or the "Act").[16] While we concur with your conclusion that because the activities of the Lieber Companies are lawful banking activities, a Glass-Steagall analysis is not required or even permissible under the Second Circuit's analysis in *Securities Industry Association v. Clarke*,[17] we find that even if the Glass-Steagall prohibitions were applied, the proposed activities are permissible.

The relevant language of Section 16 of the GSA generally prohibits national banks from "underwriting" or "dealing" in securities and stock. *See* 12 U.S.C. 24(7).[18] Neither the statute nor legislative history define the terms underwriting or dealing. Underwriting as commonly used, however, refers to the process by which newly issued securities are purchased by another firm for distribution and sale to investors. *See* Interpretive Letter No. 388(June 16, 1987), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499 (March 4, 1985).[19] Similarly, dealing in securities generally encompasses purchase and sale activities with respect to the securities of other issuers. *See* Interpretive Letter No. 388, *supra*. The Federal Reserve Board also has recognized that underwriting and dealing involve the banking entity's purchase of shares for its own account thereby incurring a principal risk. *See* Board of the Governors of the Federal Reserve System Letter, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,620 (June 27, 1986) [here-

[15]The activities approved by the Fed included maintaining and preserving Fund records, computing net asset value and other performance information regarding the Funds, preparing and filing with the SEC and state securities regulators registration statements and other required materials; preparing and filing tax returns, providing office facilities for the Funds, and coordinating communications and activities between the investment advisor and other service providers. For a complete list of the activities approved see Appendix A of the *Mellon* decision.

[16]The Glass-Steagall Act is the popular name for essentially four provisions in the Banking Act of 1933. Section 16 of the Act (12 U.S.C. 24(7)) places limits on national banks underwriting and dealing in securities and stock and prohibits national banks from purchasing or selling securities except upon the order and for the account of customers. Section 20 (12 U.S.C. 377) prohibits Federal Reserve member bank affiliation with a company engaged principally in underwriting and other securities activities. Section 21 (12 U.S.C. 378) prohibits organizations that are engaged in underwriting and other securities activities from simultaneously engaging in the business of receiving deposits. Section 32 (12 U.S.C. 78), prohibits officer, director or employee interlocks between member banks and companies that are primarily engaged in the securities activities listed in section 20.

[17]885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990) ("*Clarke*"). The court concluded that the bank's sale of mortgage pass-through certificates was encompassed within the power to carry on the business of banking under 12 U.S.C. 24(7). *Id.* at 1047 As such, the court upheld the Comptroller's determination that because the activity was an authorized banking activity the prohibitions of the Glass-Steagall Act did not apply. *Id.* at 1048.

[18]*See supra* footnote 13.

[19]Although the term underwriting may encompass a variety of activities, so-called "firm commitment underwriting" whereby one purchases an issue of securities from the issuer and then resells the securities to the public is recognized as the most common form of underwriting in the United States. *See* L. Loss, *Fundamentals of Securities Regulation* 77-85 (2d ed. 1988); *see also Schwab*, 468 U.S. at 217 n.17 (1984) (typically, the underwriter purchases securities from an issuer).

inafter the "Sovran Letter"]; *see also Schwab*, 468 U.S. at 218 n. 18 (1984) (as underwriter and dealer, a security firm engages in buying and selling securities on its own account, thereby assuming all risk of loss).

The Bank has represented that the Lieber Companies are not engaged in underwriting or dealing in the mutual funds shares that they advise. The Lieber Companies will not purchase the shares for resale to customers and have no indicia of record or beneficial ownership. Consequently, the Lieber Companies incur no principal risk and have no potential for gain with respect to the fund shares. Accordingly, the proposed activities of the Subsidiaries are not prohibited by Section 16.

In contrast, Section 21 of the Act prohibits certain kinds of securities firms from engaging in banking activities.[20] Section 21 restricts any person or organization "engaged in the business of issuing, underwriting, selling, or distributing ... stocks, bonds, debentures, notes, or other securities" from receiving deposits. 12 U.S.C. 378. Despite the different terminology the Supreme Court has held that Section 16 and Section 21 seek to draw the same line. *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 149 (1984) ("Bankers Trust I"). In considering the interplay between the two sections, the courts have found that Section 21 cannot be read to prohibit what Section 16 permits. *See Bankers Trust II*, 807 F.2d at 1057; *ICI*, 450 U.S. at 63. Thus finding that the proposed activities are permissible under Section 16 necessarily leads to the conclusion that they are not prohibited by Section 21. *See Clarke*, 885 F.2d at 1049.[21]

The prohibitions in Section 20 of the Glass-Steagall Act on affiliations between national banks and companies engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities do not apply to the Bank's proposal. *See* 12 U.S.C. 377.[22] The mutual funds are not "affiliates" of the Bank under 12 U.S.C. 221a; 12 U.S.C. 377. The common ownership and control required under the definition of an affiliate in Section 221a does not arise under the proposal. In fact, the Funds will meet the independence requirements from the Bank dictated by the 1940 Act, requiring that the Funds' boards of directors consist of a majority of persons who are not directors, officers, or employees of the Bank. *See* 15 U.S.C. 80a-10(c). Since the Funds must operate under the control of their independent boards, the relationship with the Bank cannot be viewed as prohibited by Section 20. The OCC has previously concluded that the 1940 Act confers so much authority on the disinterested members of a fund's board that control of a fund by the investment advisor appears to be precluded as a matter of law. *Decision of the Comptroller of the Currency to Charter J. & W. Seligman Trust Company. N.A., reprinted in* [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 199,463 (February 4, 1983); *see also Decision of the Comptroller of the Currency to Charter Dreyfus National Bank and Trust Company, reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,464 (February 7, 1983); *Mellon Bank Corporation* 79 Fed. Res. Bull. 626 (April 21, 1993).

Likewise, the proposal will not result in any prohibited employee interlocks between the Bank and the mutual funds as prohibited by Section 32. Section 32 provides that no officer, director, or employee of any business organization primarily engaged in the "issue, flotation, underwriting, public sale or distribution" of securities shall serve at the same time as an officer, director or employee of a member bank. *See* 12 U.S.C. 78. The Bank has represented that no officer, director, or employee of the Bank will serve as such with respect to the mutual funds and no officer, director, or employee of the mutual funds will serve as such in the Bank. The directors, officers, and employees of the independent distributor also will not overlap with those of the Bank or the Subsidiaries. Thus there are no prohibited relationships under Section 32.

Given that the proposed activities are permissible as part of the business of banking, a subtle hazards analysis as often discussed in the GSA context is unnecessary. *See Clarke*, 885 F.2d 1034.[23] Nonetheless, even applying a hazards analysis, the Bank's proposed activities are not prohibited by the GSA. In *Investment Company Institute v. Camp*, the Supreme Court found that Congress enacted the GSA to prevent the so-

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[20] Section 16 separates investment and commercial bank activities from the perspective of the commercial bank and Section 21 provides similar limitations from the investment bank's perspective. *See Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 148 (1984) ("*Bankers Trust I*"); *ICI*, 450 U.S. at 63 ("[Section] 21 presented the converse situation of § 16 and was intended to require securities firms such as underwriters or brokerage house to sever their banking connections.").

[21] Section 21's prohibitions are not triggered by the Bank's proposal. Assuming *arguendo* that the mutual funds are engaged in issuing, underwriting, selling or distributing securities, they are not receiving deposits. Likewise, while the Bank and the Subsidiaries may receive deposits, they are not engaged in issuing, underwriting, selling or distributing securities. The OCC and the FRB have indicated that a bank's sale of mutual funds as agent does not constitute Glass-Steagall distribution, even if the bank also acts as the advisor and/or administrator to the funds. *See* 12 CFR 225.125; Glidden Letter, *supra*, Sovran Letter, *supra*, Interpretive Letter No. 332, *supra*. Moreover, the Bank has represented that Lieber will resign as distributor of the Evergreen Funds and the boards of directors will appoint an independent third party as the named distributor

[22] The Supreme Court has concluded that the term "public sale" in Section 20 refers to sales as an underwriter or dealer and not sales to the public as agent. *See Schwab*, 468 U.S. at 218.

[23] *See supra* footnote 17 and accompanying text

called "subtle hazards" that might arise when a commercial bank's promotional interest in the success of particular securities investments or in the activities of its securities affiliates[24] might interfere with the bank's ability to act as an impartial source of credit or to render disinterested investment advice. *See* 401 U.S. 617, 634 (1971).[25] Since *Camp*, the Supreme Court and other courts have discussed and limited the application of these subtle hazards in several decisions. *Schwab*, 468 U.S. at 220; *ICI*, 450 U.S. at 66; *NatWest*, 821 F.2d at 815. These decisions conclude that financial institutions involved in investment advisory activities to mutual funds, retail brokerage, and a combination of advisory and brokerage activities do not raise the subtle hazards of underwriting as identified in *Camp*. *See id.* Another court has explained that the subtle hazards analysis "catalogues the various conflicts of interest and dangers that may result from a commercial bank's dealing in 'particular' securities." *Bankers Trust II*, 807 F.2d at 1067. As in *Camp*, the obvious hazard is the investment of bank funds in speculative securities. *See id.* This hazard, however, is not an issue under the Bank's proposal. Since the Bank and the Subsidiaries will act only as agent and will not purchase the mutual fund shares as principal, the Bank's assets will not be at risk.

Unlike in *Camp*, the Bank is not proposing to engage in the Glass-Steagall prohibited securities activities of underwriting and dealing. The Bank's and the Subsidiaries' involvement with the mutual funds is distinctly different from that in the traditional underwriting context. Thus there is no promotional pressure to "hold and sell" the securities or "purchase and sell" the securities for their own accounts. *See Camp*, 401 U.S. at 630; *Schwab*, 468 U.S. at 220; *see also NatWest*, 821 F.2d at 816. The investment companies issuing and redeeming the mutual fund shares are entirely separate entities governed by independent boards of directors. While the bank and the Subsidiaries perform services for the investment companies, they do not have an ownership interest in the funds or control over the funds' operations. Hence, the Bank and the Subsidiaries do not have the same pressure to make unsound loans or render biased investment advice.

Moreover, the Subsidiaries' proposed involvement with the mutual funds is analogous to activities already engaged in by national banks and their operating subsidiaries and found permissible by the OCC, other regulatory agencies and the courts. *See e.g.*, Interpretive Letter No. 403, *supra; Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas. to Establish an Operating Subsidiary to Provide Investment Advice* (September 23, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,732; *In re Security Pacific National Bank* (August 26, 1982), *reprinted in* [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284; *see also NatWest*, 821 F.2d at 816; *Mellon Bank Corporation* 79 Fed. Res. Bull. 626 (1993). None of these decisions found that the subtle hazards would preclude the proposed advisory, brokerage, and administrative activities.

Many of the hazards perceived by the court in *Camp* subsequently have been addressed by changes in regulation and market practice. For example, various disclosures and customer protections applicable to mutual funds are provided by the Interagency Statement and the Rules of Fair Practice of the NASD. Under section 23A of the Federal Reserve Act, the Bank considers the funds "affiliates" of the Bank and thereby the limitations on financial transactions between banks and their affiliates would apply. *See* 12 U.S.C. 371c and 371c-1. Moreover, the funds themselves are registered as investment companies under the 1940 Act and subject to detailed requirements. The Bank also has made various representations concerning its relationship with the Funds that seem to meet the Congressional concerns voiced by the *Camp* court.[26] Such changes minimize any risk of impairing public confidence in the bank or diminishing customer good will. Accordingly, we find it unlikely that the Subsidiaries' activities would implicate Glass-Steagall's subtle hazards, that adequate safeguards limit any such hazards from arising, and that, overall, the proposed activities are not prohibited by the GSA.

Partnership Structure

Consistent with past OCC opinions the partnership aspect of the Bank's proposal presents no difficulty given that the two partners are the wholly-owned oper-

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[24]In contrast to the proposed activities of the Subsidiaries, the securities affiliates referred to by the Court engaged in floating bond issues and underwriting stock issues. *See Camp*, 401 U.S. at 617. One effect of the GSA was to abolish these types of securities affiliates of banks. *See id.*

[25]The Court expressed deep concern with situations where banks were involved in the trading and ownership of speculative securities. *See Camp*, 401 U.S. at 616. The Court also identified other possible hazards that might arise when banks became involved in securities activities, including impairing public confidence in the bank, encouraging unsound loans to customers, and diminishing customer good will. *See id.* at 630-34.

[26]In particular, the Bank has represented that the Bank and/or the Subsidiaries will not (1) purchase shares of the Evergreen Funds for their own accounts; (2) purchase in their sole discretion in a fiduciary capacity shares of the Evergreen Funds, unless expressly authorized by the instrument, court order or local law and consistent with 12 CFR 9, Section 23B of the Federal Reserve Act, state law, and general fiduciary obligations; (3) extend credit to the Evergreen Funds, and (4) accept shares of the Evergreen Funds as collateral for a loan used to purchase shares of the Evergreen Funds

ating subsidiaries of the Bank. *See* Interpretive Letter No. 624 (June 30, 1993). The OCC repeatedly has permitted national bank operating subsidiaries to conduct activities permissible for national banks through a partnership structure. *See e.g.,* Interpretive Letter No. 622, *supra*; Interpretive Letter No. 516 (July 12, 1990), *reprinted in* [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220; Interpretive Letter No. 289 (May 15, 1984), [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,453.

Application of the Interagency Statement

The federal bank and thrift regulatory agencies issued a joint statement on retail sales of mutual funds and other nondeposit investment products by federally insured financial institutions on February 15, 1994. The Interagency Statement sets forth the uniform views of the bank regulatory agencies on standards for the safe and sound operation of banks. The Interagency Statement supersedes earlier guidance issued by the agencies and is applicable to both the Bank and the Subsidiaries.

The Statement provides specific guidance on disclosures to customers, sales location, the suitability of particular investments for particular customers, compensation of sales personnel and other sales practices. In particular, where mutual funds are recommended or sold to retail customers, the Statement provides that customers be fully informed that the products are not insured by the FDIC; are not deposits or other obligations of the institution and are not guaranteed by the institution; and are subject to investment risks, including possible loss of the principal invested. The Interagency Statement does not proscribe the use of different language for these disclosures so long as the customer receives a disclosure conveying the same information.

Similarly, with regard to securities sales and recommendations, the OCC now interprets the Interagency Statement provision on suitability to adopt standards identical to the NASD's suitability rule. *See* Article III, Section 2 of the Rules of Fair Practice, NASD Manual. Accordingly, national banks and their operating subsidiaries have the same information gathering responsibility and suitability analysis requirement with respect to money market funds as imposed by the NASD's rule. The OCC expects national banks and their operating subsidiaries to comply fully with the Interagency Statement's guidelines. The OCC is willing to consider further requests for interpretation of the Interagency Statement as it applies to particular situations.

Please be advised that if compliance difficulties arise related to these activities (including any evidence that customers were unaware of or did not understand the relationships involved between the entities), the OCC may impose additional limitations on the Subsidiaries' activities.

Conclusion

The OCC approves the Bank's operating subsidiary notice on the condition that the Bank conducts the activities as proposed in the notification letter and other written materials, and complies with the following supervisory conditions:

(1) The Bank and the Subsidiaries will maintain an adequate level of equity capital. In assessing the appropriate level of capitalization, the Bank should include within its evaluation the various risks incurred, e.g., liquidity, fiduciary, operational, and legal. The Subsidiaries also will comply with applicable SEC capital requirements.

(2) The Bank and the Subsidiaries are deemed "affiliates" of the Evergreen Funds for purposes of Sections 23A and 23B of the Federal Reserve Act and thus are subject to the restrictions on transactions between affiliates. *See* 12 U.S.C. 371c and 371c-1.

(3) The Bank's aggregate direct and indirect investments in and advances to the Subsidiaries shall not exceed an amount equal to the Bank's legal lending limit.

(4) The Bank shall not accept shares of the Evergreen Funds as collateral for a loan used to purchase shares of the Evergreen Funds.

(5) The Bank and/or the Subsidiaries will not purchase shares of the Evergreen Funds for its own account.

(6) The Bank will not purchase in its sole discretion in a fiduciary capacity shares of the Evergreen Funds, unless expressly authorized by the instrument, court order or local law and consistent with 12 CFR 9, state law, and general fiduciary obligations.

(7) The Bank and/or the Subsidiaries shall not extend credit to the Evergreen Funds (except for extensions of credit made in the ordinary course of providing custodial or cash management services to the Funds).

(8) The Bank must submit a notice to us pursuant to 12 CFR 5.34, if the Subsidiaries at some future time decide to engage in new activities, i.e. activities not covered by the current notice and our response thereto. This submission must be made even though the activities have been found to be permissible for national banks.

(9) The Bank and the Subsidiaries are subject to the Interagency Statement (2/15/94) regarding sales of nondeposit investment products.

(10) The Bank and the Subsidiaries will comply fully with all applicable laws, regulations, orders and directives of regulatory bodies and with the rules of all self-regulatory bodies including the NASD.

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818. This response is based solely on the facts as represented and any changes in the facts might require a different result. Our analysis also reflects current legal and prudential standards, and is subject to revision as future developments warrant.

Frank Maguire
Senior Deputy Comptroller for
Corporate Activities and Policy Analysis

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Appendix A
List of Administrative Services

(1) Maintaining and preserving the fund records, including financial corporate records;
(2) Computing net asset values, dividends, performance data and financial information regarding the funds;
(3) Furnishing statistical and research data;
(4) Preparing and filing with the SEC and state securities regulators registration statements (including prospectus), notices, reports and other material required to be filed under applicable laws;
(5) Preparing reports and other informational materials regarding the funds, including proxies and other shareholder communications;
(6) Providing legal and regulatory advice to the funds in connection with other administrative functions;
(7) Providing office facilities and clerical support for the funds;
(8) Developing and implementing procedures for monitoring compliance with regulatory requirements and compliance with the funds' investment objectives, policies, and restrictions as established by the boards of directors;
(9) Providing routine fund accounting services and liaison with outside auditors;
(10) Preparing and filing tax returns;
(11) Reviewing and arranging for payment of fund expenses;
(12) Providing communication and coordination services with regard to the transfer agent, custodian and other service organizations that render recordkeeping or shareholder communication services;
(13) Reviewing and providing advice to the fund regarding sales literature and marketing plans to assure regulatory compliance;
(14) Participation in seminars, meetings, and conferences designed to present information to brokers;
(15) Assisting existing funds in the development of additional portfolios;
(16) Providing reports to the fund's board with regard to its activities;
(17) Providing shareholder services; and,
(18) Providing distribution capability.*

648—May 1994

Michael E. Bleier
General Counsel
Mellon Bank, N.A.
One Mellon Bank Center
Pittsburgh, PA 15258-0001

Re: Mellon Bank, N.A., Greensburg, PA - Control No. 93-NE-08-043
Mellon Bank (DE), N.A., Wilmington, DE - Control No. 93-NE-08-044
Operating Subsidiary Notice - Mellon/Dreyfus Acquisition

Dear Mr. Bleier:

This letter responds to your notification, on behalf of Mellon Bank, N.A. and Mellon Bank (DE) (collectively, the "Bank"), of the Bank's intent to establish certain operating subsidiaries (collectively, the "Subsidiaries") to acquire most of the assets, operations, and activities of The Dreyfus Corporation. Following the acquisition, the Subsidiaries primarily will engage in investment advisory, brokerage and administrative services to the Dreyfus family of mutual funds. The Subsidiaries will not act as distributor of the mutual funds. In addition, the Bank proposes to have the Subsidiaries engage in certain other activities unrelated to mutual funds which are permissible for national banks and their operating

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*Will cease at closing.

subsidiaries, including investing and selling certain precious metals to customers; holding loans; receiving and passing payments to the parent corporation; and selling variable annuities as agent from a place of under 5,000 inhabitants.

The Bank's notification was filed with the Office of the Comptroller of the Currency ("OCC") on December 30, 1993, pursuant to 12 CFR 5.34. As provided in section 5.34, the OCC extended its 30-day review period since the Bank's proposal raised issues which required additional information and time for analysis. The OCC reviewed the Bank's proposal to determine if the proposed activities were legally permissible for national bank operating subsidiaries and to ensure that the proposal was consistent with prudent banking principles and OCC policy. On February 23, 1994, the OCC published a summary of the Bank's proposed acquisition in the Federal Register, affording interested persons an opportunity to submit comments. *See* 59 Fed. Reg. 9017 (1994). The Federal Register notice also requested comments on another pending operating subsidiary notice. The time for filing comments on both notices expired on March 28, 1994, and the OCC has considered all comments received.

In response to the request for comments, the OCC received a total of thirty-six comments with thirty-one commenters supporting the Bank's proposal. The majority of the comments came from community groups favoring approval of the Bank's proposal based primarily on the Bank's demonstrated commitment to the community and the expectation that the acquisition would result in customers having greater and easier access to a wide range of banking and investment products. Commenters stated this would particularly benefit persons with fixed incomes and limited mobility. Various bankers and trade associations provided favorable comments focusing on the legal precedents for approval, the changing nature of banking, customer protection matters, and maintaining bank competitiveness. Several commenters urged against adopting regulatory conditions that would unfairly burden banks relative to other participants in the mutual funds industry. The OCC received five comments critical of the Bank's proposal. Two of the comments raised general concerns about bank participation in mutual fund activities and the other three comments discussed individual complaints based on alleged age discrimination in employment by an ex-employee, the sale of property by another bank acquired by the Bank, and a loan made by the Bank for the establishment of an employee stock ownership plan.

Based on the information provided in the Bank's notification letter dated December 30, 1993, accompanying legal memorandum and other written materials enclosed therein, subsequent materials listed in footnote one,[1] information provided by commenters, and the OCC's analysis, we conclude that the proposed activities are permissible for national banks and their operating subsidiaries and are consistent with prior opinions of the OCC. Accordingly, the Bank may implement its proposal pursuant to 12 CFR 5.34 based on the facts as described and in accordance with the submitted materials. This letter also subjects the Bank and the Subsidiaries to all the conditions set forth in this letter.

The Bank's Proposal

The Bank proposes to establish a wholly-owned operating subsidiary, XYZ Subsidiary, to facilitate the acquisition of most of the assets, operations and activities of The Dreyfus Corporation ("Dreyfus").[2] XYZ Subsidiary will merge with Dreyfus and Dreyfus will continue as the surviving corporation. Dreyfus and its current subsidiaries will be divided into four groups after the acquisition: (1) those that will become operating subsidiaries of Mellon Bank, N.A.; (2) those that will become operating subsidiaries of Mellon Bank (DE);[3] (3) those that will become nonbank subsidiaries of Mellon Banking Corporation ("MBC"), the parent corporation of the Bank; and (4) those that will be liquidated or divested. The Bank's notice and this letter only relate to the proposed subsidiaries as listed in groups (1) and (2).[4] The acquisitions are pursuant to an Agreement and

[1]Letter from Michael E. Bleier to Michael Tiscia dated March 4, 1994; Letter from Michael E. Bleier to Michael Tiscia dated March 4, 1994 (second letter); Letter from Michael E. Bleier to Suzette Greco and Ann Jaedicke dated March 4, 1994; Letter from Michael E. Bleier to Michael Tiscia dated March 15, 1994; and the Policy Statement on Mutual Funds dated April 21, 1994 (revised). For purposes of this letter, the term "Notification" refers to each of these items as well as the Bank's notification letter, accompanying legal memorandum and other written materials enclosed therein.

[2]The Dreyfus Corporation is a corporation organized and existing in good standing under the laws of the State of New York, with its principal offices located in New York, New York. Dreyfus has operated under the Dreyfus name since 1951 and has been publicly owned since 1965. Dreyfus serves primarily as an investment advisor and manager of mutual funds and is the sixth largest mutual fund company in the United States. Dreyfus also acts as the holding company for several other entities.

[3]Dreyfus Service Organization, Inc. is the only current Dreyfus subsidiary proposed to become an operating subsidiary of Mellon Bank (DE).

[4]The current subsidiaries of Dreyfus that will continue as subsidiaries of the post-merger Dreyfus are: The Dreyfus Consumer Credit Corporation; Dreyfus-Lincoln, Inc.; Dreyfus Management, Inc., Dreyfus Personal Management, Inc.; Lion Management, Inc.; Dreyfus Precious Metals, Inc.; Dreyfus Service Corporation, Seven Six Seven Agency, Inc.; and Dreyfus Service Organization, Inc. The incoming materials provide descriptive details on the activities of each of these entities. For purposes of this letter, use of the name "Dreyfus" encompasses the holding company and these subsidiaries, unless otherwise noted. All of these entities will be bank operating subsidiaries after the merger.

Plan of Merger among MBC, Mellon Bank, N.A., XYZ Subsidiary and Dreyfus.[5]

The Subsidiaries listed in groups (1) and (2) above will be chartered under the laws of either New York or Delaware and will have offices in New York City and several other locations. None of the offices of the Subsidiaries will receive deposits, pay checks or lend money. The Dreyfus Corporation is located at 200 Park Avenue, New York, New York, and will continue to operate from that location. Following the merger, the Dreyfus management team and the Dreyfus fund managers will remain in place, and the Dreyfus name will be retained for the mutual funds it manages.[6] The Bank represents that no director, officer of employee of the Subsidiaries will serve as a director, officer or employee of the Dreyfus family of mutual funds.

The Subsidiaries will be subject to substantial regulatory requirements under the federal securities law, applicable state laws and the Rules of Fair Practice of the National Association of Securities Dealers, Inc. ("NASD"). In particular, The Dreyfus Corporation and Dreyfus Management, Inc. will continue as registered investment advisors under the Investment Advisors Act of 1940 and under all applicable state investment advisory laws. Dreyfus Service Corporation will continue as a registered broker-dealer under the Securities Exchange Act of 1934 and under all applicable state broker-dealer laws. It also will continue as a member is good standing of the NASD. In addition, as national bank operating subsidiaries, the Subsidiaries will be subject to examination and supervision by the OCC.

Under the Bank's proposal, the Subsidiaries will engage in the current activities of Dreyfus, with various exceptions. The primary business of Dreyfus is the provision of investment advisory and administrative services to registered open-end investment companies (mutual funds).[7] Dreyfus provides services to approximately 130 of its own mutual funds (the "Dreyfus Funds" or "Funds"), which have approximately $80 billion in assets. Approximately 54 percent of the assets are in money market funds, 34 percent in bond funds and 12 percent in equity funds. Dreyfus also provides investment advisory services to closed-end funds, individuals and institutional investors.

Each of the Dreyfus Funds is registered as an investment company under the Investment Company Act of 1940 ("1940 Act") and under state securities laws, as applicable. Each fund is governed by a board of directors consisting of a minimum of three directors subject to 1940 Act requirements concerning independence.[8] Shares of each fund are registered with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933 as required. All disclosure and marketing materials relating to the funds, including each fund's prospectus, will comply with applicable requirements under the 1940 Act, the Securities Act of 1933, applicable state securities laws and federal banking laws.

The Subsidiaries will continue to provide investment advisory services to the Dreyfus Funds as well as to, among others, corporate retirement plans, individuals, foundations and endowments. One or more of the Subsidiaries will act as direct advisor to the Dreyfus Funds. While Dreyfus currently acts as distributor of the funds, prior to the time the acquisition is consummated Dreyfus will resign as distributor. The respective boards of directors of the funds will contract with an independent third party to act as distributor.[9]

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[5]MBC will issue shares of its common stock for each share of Dreyfus common stock. MBC will account for the transaction as a pooling of interests. The proposed merger will have a positive impact of the capital position of the Bank. The Bank notes that the principal reasons for establishing Dreyfus as a subsidiary of the Bank, rather than a subsidiary of MBC, were to provide this major increase to the Bank's capital position and to supplement the Bank's earnings with Dreyfus' earnings.

[6]The management of the Bank has committed that Dreyfus will operate as an independent entity for at least two years subsequent to the acquisition. The Bank will be accountable for the operations of Dreyfus, as it is for all of its operating subsidiaries. MBC will provide oversight and review of the Dreyfus operations by participation on an executive committee. The Bank represents that Dreyfus will establish an Executive Committee responsible for Dreyfus' operations, which will be composed of two representatives from MBC and two from Dreyfus. The current Chief Executive Officer and President of Dreyfus will remain in place during the two-year period. The current membership of the Dreyfus Board of Directors will remain the same.

[7]As provided in the Bank's notice, Dreyfus also has seventeen financial service centers located throughout the United States. These centers provide various services, including selling shares of Dreyfus Funds solely on an agency basis. The Subsidiaries will continue these activities after the acquisition.

[8]Section 10 of the 1940 Act basically provides that at least forty percent of the directors on the board must be independent, unless certain affiliated relationships exist in which case a majority of the directors must be independent. *See* 15 U.S.C. 80a-10. The Bank represents that the Dreyfus Funds will have boards of directors independent from the Bank and the Subsidiaries.

[9]The party specifically identified as the distributor will serve as the intermediary between the funds and purchasers of fund shares. The independent distributor will be a "principal underwriter" for purposes of the 1940 Act. As provided by the Bank, the independent distributor likely will be responsible for (1) entering into distribution agreements with the Dreyfus Funds; (2) being named as the distributor in all Fund prospectuses and sales literature; (3) confirming to investors or broker-dealers all sales of Dreyfus Funds shares with a confirmation complying with Rule 10b-10 under the 1940 Act, (4) providing the required seed money for any new funds; (5) entering into agreements with broker-dealers selling the Dreyfus Funds; (6) collecting front end sales charges from broker-dealers or investors; (7) advancing commissions to broker-dealers; (8) receiving and transmitting that portion of 12b-1 payments that will be paid to broker-dealers as sales and maintenance commissions, and entering into 12b-1 agreements with broker-dealers, banks and others as contemplated by Rule 12b-1. (9) collecting back-end sales charges from redeeming shareholders, (10) paying the costs of printing and distributing prospectuses to

In conjunction with the advisory services, the Subsidiaries will provide various administrative services to the Dreyfus Funds. For example, such services may include maintaining and preserving fund records, computing net asset value and other performance information regarding the funds, preparing and filing with the SEC and state securities regulators registration statements and other required materials; preparing and filing tax returns, providing office facilities for the funds, and coordinating communications and activities between the investment advisor and other service providers. The Bank represents that these are normal administrative services substantially similar to those recently approved by the Federal Reserve Board in connection with the Mellon Bank Corporation's acquisition of The Boston Company. *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993). The Subsidiaries will receive a fee for providing the advisory and administrative services consistent with 1940 Act requirements and general industry practices.

Similar to current Dreyfus activities, the Subsidiaries also will engage in securities brokerage activities on behalf of their clients. The Subsidiaries may provide shareholder services and sell fund shares, solely on an agency basis, at financial service centers throughout the United States. The Bank represents that the Subsidiaries will not engage in underwriting or dealing. The Subsidiaries also will not sponsor or organize new mutual funds for the Dreyfus Funds family.[10] The compensation received by the Subsidiaries for brokerage services will be consistent with that customarily received by an agent and not that of a principal or dealer.[11]

In an effort to minimize any potential safety and soundness concerns, address consumer protection issues and prevent conflicts of interest, the Bank represents that the Bank and its subsidiaries will adopt a Policy Statement on Mutual Funds prior to the acquisition.[12] The Policy Statement builds upon the Bank's existing comprehensive policies governing sales of nondeposit investment products. Specific areas covered by the Policy Statement include suitability requirements, procedures to ensure that the customer understands that mutual funds are not FDIC-insured or bank obligations, differentiation between names of mutual funds and the Bank's name, use of signs to illustrate the differences between bank obligations and mutual fund shares, and independence of the funds and the funds' boards of directors. As provided in the Policy Statement, all transactions between the Bank and the Subsidiaries will be subject to Sections 23A and 23B of the Federal Reserve Act without giving effect to the exemption for bank subsidiaries. *See* 12 U.S.C. 371c(b)(2)(A).[13] The Bank has acknowledged that the voluntary commitments set forth in the Policy Statement could be formal conditions enforceable by the OCC.[14] *See* Letter from Mellon Banking Corporation and The Dreyfus Corporation to The Honorable John D. Dingell, Committee on Energy and Commerce dated February 18, 1994. Compliance with the Policy Statement is imposed as a condition of regulatory approval in the "Conclusion" section and a copy of the Statement is attached to this letter for reference. In addition, the Bank and the Subsidiaries are subject to the Interagency Statement on sales of nondeposit investment products which is discussed in the subsection of this letter entitled "Application of the Interagency Statement."

In addition to the mutual fund-related activities discussed, the Subsidiaries also will engage in several other activities generally permissible for national banks and their operating subsidiaries. Certain Dreyfus subsidiaries being acquired by the Bank currently engage in these activities.[15] These other activities include: investing and selling certain precious metals to customers; holding loans; receiving and passing payments to the parent corporation; and selling variable annuities as agent from a place of under 5,000 inhabitants.

We expect that the Bank and the Subsidiaries will conduct their operations in accordance with all appli-

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potential investors; and (11) providing other regulatory/administrative services that are typical for a distributor. The distributor will receive a fee for its distribution activities consistent with industry practice.

[10]The independent distributor may organize new mutual funds which the Subsidiaries subsequently may advise or administer. The Bank represents that it will not provide seed capital to fund these new mutual funds.

[11]The Bank anticipates that trades for the Dreyfus Funds will be executed through broker-dealers not affiliated with the Bank or the Subsidiaries. Broker-dealers will be selected to ensure best execution of such trades. These trades currently are executed for the Dreyfus Funds by unaffiliated broker-dealers. In the event an affiliated broker-dealer were used, the relationship would be governed by Section 17(e) of the 1940 Act and Rule 17e-1 concerning transactions between affiliated parties.

[12]The Bank represents that the Policy Statement will apply to Dreyfus as of the date Dreyfus becomes an operating subsidiary of the Bank.

[13]We also note that under Sections 23A and 23B of the Federal Reserve Act, the Bank considers the Funds "affiliates" of the Bank and thus subject to various requirements enacted to protect banks from potential abuses in financial transactions with affiliated companies. *See* 12 U.S.C. 371c and 371c-1.

[14]The Bank represents that it will not make any changes in the Policy Statement without prior notice to the OCC and the Federal Reserve Board. The Bank states it will not make the change if notified of objections by either agency within thirty days of the notification.

[15]As provided in the Bank's notice, however, two of the subsidiaries being acquired currently are inactive: Dreyfus Personal Management, Inc., which offers discretionary advisory services primarily to individuals, and Lion Management Inc., which acts as a commodity pool operator and commodity trading advisor for limited partnerships. While these activities generally are permissible, the Bank agrees it will give advance notice to the OCC of any decision to activate these subsidiaries after the acquisition. The Bank should submit a notice pursuant to 12 CFR 5.34.

cable laws and regulations and in a prudent manner, consistent with safe and sound banking practices.

Legality of Proposed Activities

Permissible Banking Activities

The National Bank Act provides that national banks shall have the power:

> To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.

12 U.S.C. 24(Seventh). The OCC has taken the position that Section 24(Seventh) grants broad powers for banks to engage in the business of banking, including the specifically recited powers and such other incidental powers that are reasonably necessary to perform the business of banking as a whole. *See* Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (extensive analysis concluding that such a broad view is supported by statutory construction, legislative history, case law, general circumstances, and commentators).[16] The courts have used various tests to determine whether banking activities are within the intended scope of Section 24(Seventh) and have found that permissible incidental activities include those that are similar to an express power, relate to an express power, resemble traditional banking functions or constitute financial activities. *See* Letter No. 494, *supra*, at 11-16. The five enumerated powers are examples of banking powers, but not the exclusive list. Many other activities including those proposed by the Bank, also are inherent parts of the business of banking.[17] We find that the proposed activities for the Subsidiaries are within the scope of banking activities previously considered and found permissible by the OCC, other regulatory agencies and the courts.[18]

Investment Advisory Services

The OCC has firmly established that national banks and their subsidiaries have the authority to provide investment advice as part of or incidental to the business of banking. *See e.g.*, OCC Letter form Frank Maguire (April 15, 1994); Interpretive Letter No. 622 (April 9, 1993), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 83,504; Interpretive Letter No. 367 (August 19, 1986), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,537; *Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (September 23, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,732. Investment advice also is authorized by trust powers provisions in 12 U.S.C. 92a. The courts have confirmed that bank holding company subsidiaries may act as investment advisors. *See Board of Governors of the Federal Reserve System v. Investment Company Institute,* 450 U.S. 46 (1981) ("*ICI*"); *Securities Industry Association v. Board of Governors of the Federal Reserve System,* 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988) ("*NatWest*").

Likewise, the OCC has permitted national bank subsidiaries to offer investment advice to customers and simultaneously act as investment advisor to the same mutual fund. *See* Interpretive Letter No. 403 (December 9, 1987), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627. In finding that a bank holding company may serve as investment advisor to a mutual fund, the Supreme Court has recognized that the functions of an investment advisor include management activities:

> The principal activity of an investment advisor is to manage the investment portfolio of its advisee — to invest and reinvest the funds of the client. Banks have engaged in that sort of activity for decades. As executor, trustee, or managing

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[16] As one commentator has noted:

> whatever may be legal rule as to business corporations, or municipal corporations, it seems clear that National Banks are not confined to the powers specified in the national Bank Act and those necessary to carry out those specific powers; and that in the case of National Banks. . . the test is not whether a power is necessarily incident to one of the specific powers granted, but whether it is properly implied from all of the terms used, in light of the general intent and purpose of the statute.

Trimble, *The Implied Power of National Banks to Issue Letter of Credit and Accept Bills,* 58 Yale L.J. 713, 721 (1949).

[17] *See New York State Ass'n of Life Underwriters v. New York State Banking Dept.* 598 N.Y.S. 2d 824 (N.Y. App. Div., 1993), *aff'd*, — N.Y. — (March 30, 1994) (court found similar incidental powers clause of New York banking law permitted banks to expand banking services over time consistent with evolving business practices and customers' needs).

[18] In addition, the OCC has long recognized its authority to establish operating subsidiaries as an inherent part of the business of banking *See* 31 Fed. Reg. 11459 (August. 31, 1966). Operating subsidiaries enable banks to use a different organizational structure to conduct permissible activities. The OCC has provided by regulation that national banks may choose to engage in permissible activities by means of an operating subsidiary 12 CFR 5 34 The operating subsidiary is subject to OCC examination and supervision and to the same banking laws and regulations as the parent bank unless otherwise provided by statute or regulation *Id* Thus the Bank has the authority to establish the Subsidiaries to engage in the proposed activities as long as the activities are permissible

agent of funds committed to its custody, a bank regularly buys and sells securities for its customers.

ICI, 450 U.S. at 55; *see also* OCC Letter from Daniel L. Pearson (January 13, 1993) (approving operating subsidiary to enter into a partnership that will act as a mutual fund manager) [hereinafter the "Pearson Letter"]; OCC Letter from William B. Glidden (January 14, 1988) (national bank investment advisors manage and supervise the investment and reinvestment of cash, securities or other properties comprising the assets of the mutual funds) [hereinafter the "Glidden Letter"].

Brokerage Services

Similarly, numerous OCC and court opinions confirm the long established power of banks and their subsidiaries to perform brokerage services for their customers. *See e.g., Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 207 (1984) ("*Schwab*"); *Securities Industry Association v. Comptroller of the Currency,* 577 F. Supp. 252 (D.D.C. 1983), *aff'd per curiam,* 758 F.2d 739 (D.C. Cir. 1985), *cert. denied,* 474 U.S. 1054 (1986) (brokerage issue); Interpretive Letter No. 494, *supra; In re Security Pacific National Bank* (August 26, 1982), *reprinted in* [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284. The authority of banks to provide brokerage services is within the business of banking as contemplated in 12 U.S.C. 24(Seventh) and is expressly recognized by the language of the Glass-Steagall Act.[19] The OCC has permitted securities brokerage activities by national bank subsidiaries including the purchase and/or sale, as agent, of shares in mutual funds. *See e.g.,* Interpretive Letter No. 622, *supra*; Interpretive Letter No. 403, *supra,* Interpretive Letter No. 386 (June 19, 1987), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610; Interpretive Letter No. 363 (May 23, 1986), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,533. Further, full-service brokerage, the combination of investment advisory and brokerage services, in the same national bank subsidiary previously has been approved. Interpretive Letter No. 403, *supra*; Interpretive Letter No. 386, *supra.*

An integral part of full-service brokerage is the ability to attract customers by advertising and marketing the services and products available. The Supreme Court in considering a contrary state law found that under its incidental powers a national bank can advertise any service that the bank lawfully offers. *See Franklin National Bank v. New York,* 347 U.S. 373, 377-78 (1954) ("Modern competition for business finds advertising one of the most usual and useful of weapons.") The District of Columbia Circuit has recognized, albeit in a different context, that the selling of securities necessarily involves finding and soliciting buyers:

> [N]o sensible construction of the statute [Section 16 of the Glass-Steagall Act] could say that otherwise permissible selling activities cannot involve the solicitation of buyers. The seller's very purpose in engaging a selling agent and paying a commission is to require that agent's superior ability to place the product with buyers. If placement of the product with buyers did not require any solicitation of buyers, no rational business would pay another firm to do what it could without cost to itself: passively wait for orders.

Securities Industry Association v. Board of Governors of the Federal Reserve System, 807 F.2d 1052, 1062 (D.C. Cir. 1986), *cert. denied,* 483 U.S. 1005 (1987) ("Bankers Trust II"). By analogy to the Supreme Court's *Schwab* decision approving brokerage operations, the court noted that banks must advertise to let customers know such services are available:

> It would strain credulity to assert that the circulation of a brochure of the running of an advertisement to publicize the availability of these services would mean that the brokerage services performed are now barred since no longer performed solely upon the order of the customer.

Id. at 1061.[20]

Likewise, the OCC previously has acknowledged the need of national banks to publicize banks' investment advisory, brokerage and administrative services relating to mutual funds. *See* Interpretive Letter No. 622, *supra* (making lobby materials available on services,

[19]While Section 16 of the Glass-Steagall Act placed limitations on certain securities activities of banks, this provision specifically preserved banks' power to broker such securities:

> The business of dealing in securities and stock buy the [bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue securities or stock. . .

12 U.S.C. 24(Seventh). Further discussion of Section 16 of the Glass-Steagall Act is contained in the subsection of this letter entitled "Glass-Steagall Act."

[20]We also note that nothing in the statutory language of Section 16 of the Glass-Steagall Act suggests that advertising and marketing activities are prohibited. *See* 12 U.S.C. 24(Seventh). Although a recent decision by the Federal Reserve Board approving certain mutual fund-related activities by a nonbanking subsidiary of a bank holding company recited certain representations regarding the limited nature of advertising and marketing in which the applicant proposed to engage, the Board did not find that advertising and marketing are prohibited by the Glass-Steagall Act. *See Mellon Bank Corporation,* 79 Fed. Res. Bull. 626 (1993).

placing newspaper advertisements, sending statement stuffers and providing other descriptions of the variety of services that are available); Pearson Letter, *supra* (as mentioned in the incoming letter, preparing and distributing explanatory materials concerning the investment portfolios); Glidden Letter, *supra* (furnishing prospectus or sales literature on funds upon request, having advertisements and brochures listing mutual funds available through the bank and the bank's services); *Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (September 23, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,732 (generating and distributing an advisory newsletter with recommendations for the purchase of specific securities); *see also* Interagency Statement, which acknowledges banks advertise and market uninsured investment products to customers and provides for full disclosure.

Based on existing judicial and agency precedent, we find that providing advertising and marketing support relating to mutual funds is an integral part of permissible brokerage and advisory services and thus is part of or incidental to the business of banking under the National Bank Act. The federal securities laws and regulations prohibit materially misleading or inaccurate representations in connection with offers and sales of mutual funds and heavily regulate the content of advertising, marketing materials, and other communications to potential purchasers of mutual fund shares. The federal banking regulators also have adopted an Interagency Statement which sets forth additional provisions governing advertising and marketing by federally insured financial institutions. Further, consistent with the Bank's Policy Statement on Mutual Funds, advertising and other marketing by the Subsidiaries of the Dreyfus Funds will include complete and accurate disclosure. Accordingly, ample regulatory safeguards will apply to any advertising and marketing conducted by the Subsidiaries to address any potential safety and soundness concerns and to provide customer protections.

Administrative Services

In conjunction with investment advisory and brokerage services, the OCC also has permitted national banks and their operating subsidiaries to provide a variety of administrative and shareholder services with respect to the operation of a mutual fund. *See, e.g.*, Glidden Letter, *supra* (providing various administrative services and acting as investment advisor to mutual funds); Interpretive Letter No. 386, *supra* (providing recordkeeping, accounting, and other services in connection with 12b-1 and similar plans); Interpretive Letter No. 332 (March 8, 1985), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,502 (recordkeeping, order execution functions, and shareholder information). These administrative functions are incidental to the related provision of investment advisory and brokerage services.

Likewise, the Federal Reserve Board recently has approved a nonbanking subsidiary of a bank holding company to provide various administrative and advisory services to mutual funds. *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993). The Fed approved administrative activities substantially similar to those proposed by the Bank.[21] The Fed reasoned that such administrative activities generally are ministerial or clerical in nature and do not impart impermissible "control" or policy-making authority over the mutual fund. *See id.* at 10-11. As the Board noted, mutual funds are governed by a disinterested board of directors dictated by various independence requirements of the 1940 Act and ultimate control over the funds rests with the board of directors. *Id.* Accordingly, because the administrative services the Bank proposes to provide are substantially similar to those previously approved, we find such services are permissible.

The Glass-Steagall Act

Apart from the authorities discussed above allowing national banks and their operating subsidiaries to engage in the proposed activities as part of or incidental to the business of banking, we also have examined the Bank's proposal under the Glass-Steagall Act ("GSA" or the "Act").[22] While we concur with your conclusion that because the activities of the proposed Subsidiaries are lawful banking activities, a Glass-Steagall analysis is not required or even permissible under the Second Circuit's analysis in *Securities Industry Association v.*

[21]The activities approved by the Fed included maintaining and preserving Fund records, computing net asset value and other performance information regarding the Funds, preparing and filing with the SEC and state securities regulators registration statements and other required materials; preparing and filing tax returns, providing office facilities for the Funds, and coordinating communications and activities between the investment advisor and other service providers. For a complete list of the activities approved see Appendix A of the *Mellon* decision.

[22]The Glass-Steagall Act is the popular name for essentially four provisions in the Banking Act of 1933. Section 16 of the Act (12 U.S.C. 24(Seventh)) places limits on national banks underwriting and dealing in securities and stock and prohibits national banks from purchasing or selling securities except upon the order and for the account of customers. Section 20 (12 U.S.C. 377) prohibits Federal Reserve member bank affiliation with a company engaged principally in underwriting and other securities activities. Section 21 (12 U.S.C. 378) prohibits organizations that are engaged in underwriting and other securities activities from simultaneously engaging in the business of receiving deposits. Section 32 (12 U.S.C. 78), prohibits officer, director or employee interlocks between member banks and companies that are primarily engaged in the securities activities listed in section 20.

Clarke,[23] we find that even if the Glass-Steagall prohibitions were applied, the proposed activities are permissible.

The relevant language of Section 16 of the GSA generally prohibits national banks from "underwriting" or "dealing" in securities and stock. *See* 12 U.S.C. 24(Seventh).[24] Neither the statute nor legislative history define the terms underwriting or dealing. Underwriting as commonly used, however, refers to the process by which newly issued securities are purchased by another firm for distribution and sale to investors. *See* Interpretive Letter No. 388 (June 16, 1987) *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499 (March 4, 1985).[25] Similarly, dealing in securities generally encompasses purchase and sale activities with respect to the securities of other issuers. *See* Interpretive Letter No. 388, *supra*. The Federal Reserve Board also has recognized that underwriting and dealing involve the banking entity's purchase of shares for its own account thereby incurring a principal risk. *See* Board of the Governors of the Federal Reserve System Letter, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,620 (June 27, 1986) [hereinafter the "Sovran Letter"]; *see also Schwab*, 468 U.S. at 218 n.18 (1984) (as underwriter and dealer, a security firm engages in buying and selling securities on its own account, thereby assuming all risk of loss).

The Bank has represented that the proposed Subsidiaries will not engage in underwriting or dealing in the shares of the Dreyfus Funds that they advise. The Subsidiaries will not purchase the shares for resale to customers and will have no indicia of record or beneficial ownership. Consequently, the Subsidiaries will incur no principal risk and have no potential for gain with respect to the fund shares. Accordingly, the proposed activities of the Subsidiaries are not prohibited by Section 16.

In contrast, Section 21 of the Act prohibits certain kinds of securities firms from engaging in banking activities.[26] Section 21 restricts any person or organization "engaged in the business of issuing, underwriting, selling, or distributing. . .stocks, bonds, debentures, notes, or other securities" from receiving deposits. 12 U.S.C. 378. Despite the different terminology the Supreme Court has held that Section 16 and Section 21 seek to draw the same line. *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 149 (1984) ("*Bankers Trust I*"). In considering the interplay between the two sections, the courts have found that Section 21 cannot be read to prohibit what Section 16 permits. *See Bankers Trust II*, 807 F.2d at 1057; *ICI*, 450 U.S. at 63. Thus funding that the proposed activities are permissible under Section 16 necessarily leads to the conclusion that they are not prohibited by Section 21. *See Clarke*, 885 F.2d at 1049.[27]

The prohibitions in Section 20 of the Glass-Steagall Act on affiliations between national banks and companies engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities do not apply to the Bank's proposal. *See* 12 U.S.C. 377.[28] The mutual funds are not "affiliates" of the Bank under 12 U.S.C. 221a; 12 U.S.C. 377. The common ownership and control required under the definition of an affiliate in Section 221a does not arise under the proposal. In fact, the Funds will meet the independence requirements from the Bank dictated by the 1940 Act, requiring that the Funds' boards of directors consist of a majority of persons who are not directors, officers, or employees of the Bank. *See* 15 U.S.C. 80a-10(c). Because the Funds must operate under the control of their independent boards, the relationship with the Bank cannot be viewed as prohibited by Section 20. The OCC has previously concluded that the 1940 Act confers to much authority on the disinterested members of a fund's

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[23] 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990) ("*Clarke*"). The court concluded that the bank's sale of mortgage pass-through certificates was encompassed within the power to carry on the business of banking under 12 U.S.C. 24(Seventh). *Id.* at 1047. As such, the court upheld the Comptroller's determination that because the activity was an authorized banking activity the prohibitions of the Glass-Steagall Act did not apply. *Id.* at 1048.

[24] *See supra* footnote 19.

[25] Although the term underwriting may encompass a variety of activities, so-called "firm commitment underwriting" whereby one purchases an issue of securities from the issuer and then resells the securities to the public is recognized as the most common form of underwriting in the United States. *See* L. Loss, *Fundamentals of Securities Regulation* 77-85 (2d ed. 1988); *see also Schwab*, 468 U.S. at 217 n.17 (1984) (typically, the underwriter purchases securities from the issuer)

[26] Section 16 separates investment and commercial bank activities from the perspective of the commercial bank and Section 21 provides similar limitations from the investment bank's perspective. *See Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 148 (1984) ("*Bankers Trust I*"); *ICI*, 450 U.S. at 63 ("[Section] 21 presented the converse situation of § 16 and was intended to require securities firms such as underwriters or brokerage houses to sever their banking connections.").

[27] Section 21's prohibition are not triggered by the Bank's proposal. Assuming *arguendo* that the mutual funds are engaged in issuing, underwriting, selling or distributing securities, they are not receiving deposits. Likewise, while the Bank and the Subsidiaries may receive deposits, they are not engaged in issuing, underwriting, selling or distributing securities. The OCC and the FRB have indicated that a bank's sale or mutual funds as agent does not constitute Glass-Steagall distribution, even if the bank also acts as the advisor and/or administrator to the funds. *See* 12 CFR 225.125; Glidden Letter, *supra*; Sovran Letter, *supra*; Interpretive Letter No. 332, *supra*. Moreover, the Bank has represented that Dreyfus will resign as distributor of the Dreyfus Funds and the boards of directors will appoint an independent third party as the named distributor.

[28] The Supreme Court has concluded that the term "public sale" in Section 20 refers to sales as an underwriter or dealer and not sales to the public as agent. *See Schwab*, 468 U.S. at 218.

board that control of a fund by the investment advisor appears to be precluded as a matter of law. *Decision of the Comptroller of the Currency to Charter J.&W. Seligman Trust Company, N.A., reprinted in* [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,463 (February 4, 1983); *see also Decision of the Comptroller of the Currency to Charter Dreyfus National Bank and Trust Company, reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,464 (February 7, 1983); *Mellon Bank Corporation* 79 Fed. Res. Bull. 626 (April 21, 1993).

Likewise, the proposal will not result in any prohibited employee interlocks between the Bank and the mutual funds as prohibited by Section 32. Section 32 provides that no officer, director, or employee of any business organization primarily engaged in the "issue, flotation, underwriting, public sale, or distribution" of securities shall serve at the same time as an officer, director or employee of a member bank. *See* 12 U.S.C. 78. The Bank has represented that no officer, director, or employee of the Bank will serve as such with respect to the mutual funds and no officer, director, or employee of the mutual funds will serve as such in the Bank. The directors, officers, and employees of the independent distributor also will not overlap with those of the Bank or the Subsidiaries. Thus there are no prohibited relationships under Section 32.

Given that the proposed activities are permissible as part of the business of banking, a subtle hazards analysis as often discussed in the GSA context is unnecessary. *See Clarke*, 885 F.2 1034.[29] Nonetheless, even applying a hazards analysis, the Bank's proposed activities are not prohibited by the GSA. In *Investment Company Institute v. Camp*, the Supreme Court found that Congress enacted the GSA to prevent the so-called "subtle hazards" that might arise when a commercial bank's promotional interest in the success of particular securities investments or in the activities of its securities affiliates[30] might interfere with the bank's ability to act as an impartial source of credit or to render disinterested investment advise. *See* 401 U.S. 617, 634 (1971).[31] Since *Camp*, the Supreme Court and other courts have discussed and limited the application of these subtle hazards in several decisions. *Schwab*, 468 U.S. at 220; *ICI*, 450 U.S. at 66; *NatWest*, 821 F.2d at 815. These decisions conclude that financial institutions involved in investment advisory activities to mutual funds, retail brokerage, and a combination of advisory and brokerage activities do not raise the subtle hazards of underwriting as identified in *Camp*. *See id.* Another court has explained that the subtle hazards analysis "catalogues the various conflicts of interest and dangers that may result from a commercial bank's dealing in 'particular' securities." *Bankers Trust II*, 807 F.2d at 1067. As in *Camp*, the obvious hazard is the investment of bank funds in speculative securities. *See id.* This hazard, however, is not an issue under the Bank's proposal. Since the Bank and the Subsidiaries will act only as agent and will not purchase the mutual fund shares as principal, the Bank's assets will not be at risk.

Unlike in *Camp*, the Bank is not proposing to engage in the Glass-Steagall prohibited securities activities of underwriting and dealing. The Bank's and the Subsidiaries' involvement with the mutual funds is distinctly different from that in the traditional underwriting context. Thus there is no promotional pressure to "hold and sell" the securities or "purchase and sell" the securities for their own accounts. *See Camp*, 401 U.S. at 630; *Schwab*, 468 U.S. at 220; *see also NatWest*, 821 F.2d at 816. The investment companies issuing and redeeming the mutual fund shares are entirely separate entities governed by independent boards of directors. While the Bank and the Subsidiaries perform services for the investment companies, they do not have an ownership interest in the Funds or control over the Funds' operations. Hence, the Bank and the Subsidiaries do not have the same pressure to make unsound loans or render biased investment advice.

Moreover, the Subsidiaries' proposed involvement with the mutual funds is analogous to activities already engaged in by national banks and their operating subsidiaries and found permissible by the OCC, other regulatory agencies and the courts. *See e.g.*, Interpretive Letter No. 403, *supra; Decision of the Comptroller of the Currency Concerning an Application by American National bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (September 23, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 99,732; *In re Security Pacific National Bank* (August 26, 1982), *reprinted in* [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284; *see also NatWest*, 821 F.2d at 816; *Mellon Bank Corporation* 79 Fed. Res. Bull. 626 (1993). None of these decisions found that the subtle hazards would preclude the proposed advisory, brokerage, and administrative activities.

Many of the hazards perceived by the court in *Camp* subsequently have been addressed by changes in

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[29] *See supra* footnote 23 and accompanying text.

[30] In contrast to the proposed activities of the Subsidiaries, the securities affiliates referred to by the Court engaged in floating bond issues and underwriting stock issues. *See Camp*, 401 U.S. at 617. One effect of the GSA was to abolish these types of securities affiliates of banks. *See id.*

[31] The Court expressed deep concern with situations where banks were involved in the trading and ownership of speculative securities. *See Camp*, 401 U.S. at 616. The Court also identified other possible hazards that might arise when banks became involved in securities activities, including impairing public confidence in the bank, encouraging unsound loans to customers, and diminishing customer good will. *See Id.* at 630-34.

regulation and market practice. For example, various disclosures and customer protections applicable to mutual funds are provided by the Interagency Statement and the Rules of Fair Practice of the NASD. Under sections 23A and 23B of the Federal Reserve Act, the Bank considers the funds "affiliates" of the Bank and thereby the limitations on financial transactions between banks and their affiliates would apply. *See* 12 U.S.C. 371c and 371c-1. Moreover, the funds themselves are registered as investment companies under the 1940 Act and subject to detailed requirements. The Bank also has made various representations concerning its relationship with the Funds that seem to meet the Congressional concerns voice by the *Camp* court.[32] These kinds of changes minimize any risk of impairing public confidence in the bank or diminishing customer good will. Accordingly, we find it unlikely that the Subsidiaries' activities would implicate Glass-Steagall's subtle hazards, that adequate safeguards limit any such hazards from arising, and that, overall, the proposed activities are not prohibited by the GSA.

Other Proposed Activities Unrelated to Proposed Mutual Fund Activities

Several Dreyfus subsidiaries being acquired engage in other activities generally permissible for national banks and their operating subsidiaries. Based on the Bank's factual descriptions, we find that these proposed activities are consistent with prior OCC opinions and the Subsidiaries may engage in such activities.

The Bank proposes to acquire a subsidiary engaged in the business of investing and selling to its customers certain precious metals (i.e., gold, silver and platinum bullion, American gold eagle coins and Canadian maple leaf coins). National banks have express authority to buy and sell "coin and bullion" under 12 U.S.C. 24(Seventh). The OCC has permitted national banks to buy and sell, as agent for customers and for the bank's own account, gold, silver, and platinum coins and bullion. *See e.g.,* Interpretive Letter No. 553 (May 2, 1991), *reprinted in* [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,300; Interpretive Letter No. 390 (July 28, 1987), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,614; Interpretive Letter No. 326 (January 17, 1986), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,496.

Another proposed subsidiary will hold certain loans previously made in 1992 which are secured by shares of the Dreyfus Funds. As part of or incidental to the business of banking, national banks and their operating subsidiaries may make and hold loans. 12 U.S.C. 24(Seventh); *see also* 12 CFR 7.7379. Because the Bank has represented that holding the loans that predated this acquisition is the only activity engaged in by this subsidiary, such activity is permissible regardless of the fact that the loans are secured by Dreyfus shares.[33] Another subsidiary will engage only in receiving payments under a Noncompetition Agreement and passing them to the parent Dreyfus Corporation. The subsidiary is a party to a Noncompetition Agreement with The Bank of New York (Delaware), which expires in 1995. This activity also is permissible as part of or incidental to the business of banking under 12 U.S.C. 24(Seventh).

Lastly, Mellon Bank (DE) proposes to acquire a Dreyfus subsidiary that engages in the sale, as agent, of variable annuity products. This subsidiary ill become a subsidiary of MBC Insurance Agency, located in Lewes, Delaware, a place of under 5,000 inhabitants.[34] Based on this representation, the OCC's approval includes the sale, as agent, of insurance and annuities products. The subsidiary will engage in activities consistent with 12 U.S.C. 92. The OCC previously has concluded and maintains that national banks and their operating subsidiaries may buy and sell annuities as agent for customers under authority granted by 12 U.S.C. 24(Seventh). *See e.g.,* Interpretive Letter No. 499 (February 12, 1990), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090; Interpretive Letter No. 428 (May 11, 1988), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,562; Interpretive Letter No. 331 (April 4, 1985), *reprinted in* [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,501.[35] This subsidiary should be particularly

[32] In particular, the Bank has represented that the Bank and/or the Subsidiaries will not (1) purchase shares of the Dreyfus Funds for their own accounts; (2) purchase shares of the Dreyfus Funds for any third party account over which they have discretionary authority except as authorized by the instrument, the beneficiaries of such account court order or local law; (3) extend credit to the Dreyfus Funds, and (4) make a loan for the purpose of purchasing shares of the Dreyfus Funds As discussed previously, the Bank and its subsidiaries have committee to adopting a Policy Statement on the sale of non-deposit investment products, including mutual funds, which incorporates, and in some respects goes beyond, current regulatory guidelines and Congressional proposals *See* discussion *supra* at 6.

[33] This subsidiary will not acquire other loans to hold in the future. In addition, one of the conditions of this approval is that the Bank will not accept shares of the Dreyfus Funds as collateral for loans used to purchase shares of the Dreyfus Funds. The Bank has represented that it will not make any loans for the purpose of purchasing shares of the Dreyfus Funds.

[34] MBC Insurance Agency, Inc. is a subsidiary of Mellon Bank (DE) which the OCC previously has approved to engage in general insurance agency activity.

[35] Although a recent decision in the Fifth Circuit found to the contrary the OCC's position remains that national banks may sell annuities pursuant to authority found in 12 U.S.C. 24(Seventh). *See Variable Annuity Life Ins. Co v. Clarke*, 998 F.2d 1295 (5th Cir 1993), *reh'g denied, Variable Annuity Life Ins. Co. v. Ludwig*, 13 F.3d 833 (5th Cir January 13, 1994), *petition for cert. filed,* —U.S.L.W.— (April 13, 1994).

mindful of the requirements of the Interagency Statement that pertain to annuities sales.

Application of the Interagency Statement

The federal bank and thrift regulatory agencies issued a joint statement on retail sales of mutual funds and other nondeposit investment products by federally insured financial institutions on February 15, 1994. The Interagency Statement sets forth the uniform view of the bank regulatory agencies on standards for the safe and sound operation of banks. The Interagency Statement supersedes earlier guidance issued by the agencies and is applicable to both the Bank and the Subsidiaries.

The Interagency Statement sets forth specific guidelines which pertain to the sale of mutual funds shares, as well as to related advertising and promotional activities, and provides that banks should market such nondeposit products in a manner that is not misleading or confusing to customers as to the nature of the products and the risks. The Statement provides guidance on disclosures to customers, sales location, the suitability of particular investments for particular customers, compensation of sales personnel and other sales practices. In particular, where mutual funds are recommended or sold to retail customers, the Statement provides that customers be fully informed that the products are not insured by the FDIC; are not deposits or other obligations of the institution and are not guaranteed by the institution; and are subject to investment risks, including possible loss of the principal invested. The Interagency Statement does not proscribe the use of different language for these disclosures so long as the customer receives a disclosure conveying the same information.

The Interagency Statement applies to the Bank and the Subsidiaries when:

- sales or recommendations are made by employees of the Bank;
- sales or recommendations are made by employees of the Subsidiaries occurring on the Bank's premises, including telephone sales or recommendations and sales or recommendations initiated by mail; and
- sales are made by employees of the Subsidiaries resulting from a referral of retail customers to the Subsidiaries by the Bank.

With respect to other sales activities, the Bank has represented that the Subsidiaries will provide the Interagency Statement disclosures in an acknowledgement that is contained in the application form, the prospectus, confirmations, periodic statements, supplemental (i.e. post-prospectus) sales literature, and brochures that contain promotional or sales material.[36] In any other customer contact involving a sales presentation, solicitation or investment recommendation or in any advertising, the Subsidiaries will comply with applicable SEC and NASD requirements and will also specifically disclose the lack of FDIC insurance.[37] *See e.g., NASD Notice to Members 94-16* (March 1994); *NASD Notice to Members 93-87* (December 1993).[38]

With regard to securities sales and recommendations, the OCC now interprets the Interagency Statement provision on suitability to adopt standards identical to the NASD's suitability rule. *See* Article III, Section 2 of the Rules of Fair Practice, NASD Manual. Accordingly, national banks and their operating subsidiaries have the same information gathering responsibility and suitability analysis requirement with respect to money market funds as imposed by the NASD's rule. The OCC expects national banks and their operating subsidiaries to comply fully with the Interagency Statement's guidelines. The OCC is willing to consider further requests for interpretation of the Interagency Statement as it applies to particular situations.

Please be advised that if compliance difficulties arise related to these activities (including any evidence that customers were unaware of or did not understand the relationships involved between the entities), the OCC may impose additional limitations on the Subsidiaries' activities.

Conclusion

The OCC approves the Bank's operating subsidiary notice on the condition that the Bank conducts the activities as proposed in the Notification and complies with the following supervisory conditions:

(1) The Bank and the Subsidiaries will maintain an adequate level of equity capital. In assessing the appropriate level of capitalization, the Bank should include within its evaluation the various risks incurred, e.g., liquidity, fiduciary, operational, and legal. The

[36] Further, the Bank represents that the Subsidiaries will provide the Interagency Statement disclosures in any advertisement by the Subsidiaries that makes a comparison to a bank deposit.

[37] We note that the Bank has represented that the Mellon name will not be linked in advertisements, solicitations or sales literature (except to the extent required to be mentioned in the prospectus) to the Dreyfus Funds.

[38] The NASD in Notice 93-87 directs all members to provide full and fair disclosure in all oral and written communications to customers, including in particular the risk to principal. *See NASD Notice to Members 93-87* (December 1993).

Subsidiaries also will comply with applicable SEC capital requirements.

(2) The Bank and the Subsidiaries are deemed "affiliates" of the Dreyfus Funds for purposes of Sections 23A and 23B of the Federal Reserve Act and thus are subject to the restrictions on transactions between affiliates. *See* 12 U.S.C. 371c and 371c-1.

(3) The Bank's aggregate direct and indirect investments in and advances to the Subsidiaries shall not exceed an amount equal to the Bank's legal lending limit.

(4) The Bank shall not accept shares of the Dreyfus Funds as collateral for a loan used to purchase shares of the Dreyfus Funds.

(5) The Bank and/or the Subsidiaries will not purchase shares of the Dreyfus Funds for its own account.

(6) The Bank will not purchase in its sole discretion in a fiduciary capacity shares of the Dreyfus Funds, unless expressly authorized by the instrument, court order or local law and consistent with 12 CFR 9, state law, and general fiduciary obligations.

(7) The Bank and/or the Subsidiaries shall not extend credit to the Dreyfus Funds (except for extensions of credit made in the ordinary course of providing custodial or cash management services to the Funds).

(8) The Bank and the Subsidiaries are subject to the Interagency Statement (2/15/94) regarding sales of nondeposit investment products as described on pages 19-20 of this letter. With respect to other sales activities, the Subsidiaries will provide the disclosures as described on page 20 of this letter.

(9) The Bank and the Subsidiaries must comply with each of the voluntary commitments contained in the Bank's Policy Statement on Mutual Funds. A copy of the Policy Statement is attached.

(10) The Bank will submit an action plan acceptable to the OCC that sets forth the post merger management reporting structure and organization chart which specifically defines lines of authority, responsibility, and accountability for the Subsidiaries and establishes information systems to monitor and measure the impact of the transaction going forward.

(11) The Bank will submit an action plan acceptable to the OCC which specifies the scope and timing and details of how the holding company's audit and compliance function will oversee the audit and compliance functions at the Subsidiaries.

(12) The Bank must submit a notice to the OCC pursuant to 12 CFR 5.34, if the Subsidiaries at some future time decide to engage in new activities, i.e. activities not covered by the current notice and the OCC's response to the notice, including activating the subsidiaries being acquired that are currently inactive. This submission must be made even through the activities have been found to be permissible for national banks.

(13) The Bank and the Subsidiaries will comply fully with all applicable laws, regulations, orders and directives of regulatory bodies and with the rules of all self-regulatory bodies including the NASD.

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818. This response is based solely on the facts as represented and any changes in the facts might require a different result. Our analysis also reflects current legal and prudential standards, and is subject to revision as future developments warrant.

Frank Maguire
Senior Deputy Comptroller for
Corporate Activities and Policy Analysis

* * *

649—May 1994

Mr. Jack Kelly
President & Chief Executive Officer
Blackfeet National Bank
P.O. Box 730
Browning, Montana 59417-0730

Dear Mr. Kelly:

In its November 8, 1993, letter to the Comptroller of the Currency ("OCC") Blackfeet National Bank (the "Bank") advised of its intention to market a new Retirement CD. The Bank has furnished the OCC with information concerning the product. The information includes a description of the product dated May 5, 1994, several legal opinions from outside law firms that address Federal deposit insurance and tax issues related to the product,[1] draft promotional materials dated February 26, 1994, and a license agreement between the Bank and American Deposit Corp., dated January 14, 1994.

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[1] The legal opinions furnished are dated May 2, 1989; January 28, 1991; November 24, 1993; and December 17, 1993.

(Collectively, this information is referred to herein as the "Information.").

This is to inform you that based on the Information, the OCC has no objection if the Bank proceeds with its plans to market and offer the Retirement CD provided that the program is operated in a safe and sound manner in accordance with the conditions sets forth below. We express no opinion on the deposit insurance status of the Retirement CD under the Federal Deposit Insurance Act, nor on the tax treatment of the Retirement CD under the Internal Revenue Code. Should it choose to offer the Retirement CD, the OCC expects the Bank accurately to represent the risks and economics of the product, the deposit insurance status and the tax treatment of the Retirement CD in its dealings with actual and prospective customers. A change in the product's structure or terms, or the emergency of safety and soundness concerns associated with either the product or the manner in which the Bank is administering the product, may result in a revocation of our no objection position. In that event, the OCC reserves the right to take any appropriate actions.

I. Summary

The Bank has represented the basic terms of the Retirement CD to be as follows. It will be offered to individuals who will open an account by making a deposit with the Bank. At the time of the initial deposit, the customer will choose a maturity date for the account. During the period before the maturity date, interest will be credited to the account. Each customer will be entitled to select a term of from one to five years during which the interest rate will remain fixed, and after which the rate will fluctuate at the Bank's discretion, in accordance with its cost of funds. Additional deposits can be made up until the maturity date.

On the maturity date the customer will select from various options for repayment. These options will permit the customer to withdraw up to two-thirds of the balance in the customer's account (principal plus accrued interest) on the maturity date. The balance of the account will be distributed to the customer in fixed periodic amounts which will include interest, for the customer's life. The period amounts will be determined with reference to permanent purchase rate guarantees (*e.g.*, an assumed minimum interest rate of 3 percent at competitive interest rates, and will include a simple refund feature. Under the refund feature, the customer (or his estate or beneficiary) will be guaranteed to receive an amount at least equalling the customer's account balance on the maturity date.

The Bank has represented that it will pay deposit insurance assessments to the Federal Deposit Insurance Corporation (the "FDIC"), as required by 12 U.S.C. 1817, on the total customer account contributions, plus interest which, until maturity, accrues on the account. In addition, the Bank has stated that the funds received will be subject to Federal Reserve Board Regulation D, 12 CFR 204, which places reserve requirements on bank deposits. Finally, the Bank has represented that the funds received, plus accrued interest will be recorded on the Bank's general ledger account and accounted for in the same manner as bank deposits, and will be employed to further the Bank's growth and development through lending in the normal course, or through other legally permissible investments.

A discussion of our legal analysis is set forth below, along with guidance on actions and procedures which we believe are appropriate in order for the product to be offered and administered in a manner which is consistent with safe and sound banking practices.

II. Legal Analysis

National banks are expressly authorized to receive deposits and enter into contracts and have broad authorizations to borrow and otherwise fund their operations. Twelve U.S.C. 24(Seventh) which contains a broad grant of authority to national banks, provides in pertinent part that national banks have the power to exercise —

> all such incidental powers as shall be necessary to carry on the business of banking; [1] by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; [2] by receiving deposits; [3] by buying and selling exchange, coin, and bullion; [4] by loaning money on personal security; and [5] by obtaining, issuing and circulating notes. [Bracketed numbers added.]

The statutory language and legislative history of § 24(Seventh) make clear that the business of banking is not confined to the five enumerated powers. The legislative history of § 24(Seventh) supports a broad reading of the business of banking. *See* Letter No. 494 (December 20, 1989) reprinted in [1989 - 1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 for a full discussion of the statute's legislative history and case law interpretations concerning the scope of the statue. In addition to the authorization to engage in the business of banking set forth in § 24(Seventh), national banks are expressly authorized to enter into contracts under 12 U.S.C. 24(Third).[2]

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[2]The United States Supreme Court has confirmed their authority to borrow money. *Wyman v. Wallace*, 201 U.S. 230, 243 (1906).

In construing the nature and scope of permissible banking activities, it is instructive to note that Congress has indicated banks must be afforded flexible alternatives to fund their operations. This belief is implicit in the 1982 repeal of 12 U.S.C. 82, which is used to limit national bank borrowings.[3] The legislative history of the repeal evidences a clear recognition on the part of Congress that to remain competitive, national banks must be able to fund their operations without unwarranted restraints.

> Statutory limitations on the liabilities of national banks have remained essentially unchanged since original enactment of the National Bank Act in 1864. Since that time, however, the nature of the banking business—especially the manner in which banks are funded—has altered considerably. The rigid limitations of § 82 adversely restrain bank flexibility and competitively disadvantage national banks. Many states have no such statutory restraints upon state-chartered institutions.

Senate Rep. No. 97-536, P.L. 97-320, 96 Stat. 1469 (1982), at 60.

In the instant case, the express authorizations for the Bank to receive deposits and enter into contracts, coupled with its powers to incur liabilities and fund its operations, clearly make the Retirement CD an authorized Bank activity. The inherent relationship that the Retirement CD customer has with the Bank is that of depositor or creditor. The customer places funds with the Bank and in turn receives the Bank's promise to repay the amount it has received, plus interest. This promise forms the very basis of the depositor or creditor/bank relationship.

The fact that the product is structured to provide for interest payments keyed in part to the expected life of the depositor does not change the intrinsic nature of the Retirement CD as an authorized bank product. Modernizing bank practices to comport with ever changing customer needs is permissible, provided that the practices remain fundamentally what is authorized by the Act. In addition, utilizing creative funding techniques is a desirable, indeed necessary action for national banks.

In *M&M Leasing Corporation v. Seattle First National Bank*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978) ("*M&M Leasing*"), the court addressed the issue of whether a national bank may engage in the leasing of motor vehicles. The court concluded that leasing in effect constitutes a loan of money secured by the leased property and is therefore incidental to the "loaning of money on personal security" which is the fourth express power provided in § 24(Seventh). In reaching its conclusion, the court drew comfort from the fact that "commentators uniformly have recognized that the [Act] did not freeze the practices of national banks in their nineteenth century forms," and added "we believe the powers of national banks in their nineteenth century forms," and added "we believe the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking." *Id.* at 1382.

Similarly, in *American Insurance Association v. Clarke*, 656 F. Supp. 404 (D.C.C. 1987) *aff'd*, 865 F.2D 278 (D.C. Cir. 1988) ("*AMBAC*") the court upheld the comptroller's determination that a national bank's issuance of standby credit in the form of municipal bond insurance was the "functional equivalent" of the issuance of a letter of credit, which is a permissible banking activity under Section 24(Seventh). The court strongly endorsed the OCC's position that in determining whether the activity in question constitutes part of the business of banking, the Comptroller may "look beyond the label given a certain activity to determine whether or not it is permissible." 656 F. Supp. at 408. Although neither letters of credit nor municipal bond insurance are specifically enumerated as permissible bank products under the Act, the court recognized that extending credit is a fundamental banking practice that can take a variety of forms, regardless of the label given the activity. The court emphasized that the bank powers analysis should focus on the substance of the transaction in question and not proceed "from a narrow and artificially rigid view of both the business of banking and the statute that governs that business." *Id.* at 408.

A national bank's express powers allow it to design products which augment its traditional bank activities. For example, in *Securities Industry Association v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 110 S.Ct. 1113 (1990) ("*SIA v. Clarke*"), a national bank was permitted to sell "pass-through" certificates on the basis that this activity is authorized by the Act because it is "convenient and useful" in connection with the bank's sale of mortgage loans. Unlike in *M&M Leasing*, *AMBAC* and *SIA v. Clarke*, however it is not necessary to view the Retirement CD as a product which is "incidental," or "useful" to the Bank or a "functional equivalent" used by the Bank in carrying out the business of banking. The product represents the very essence of banking which is embodied in a bank's express authority to accept deposits and enter into contracts, and authority to incur liabilities and fund its operations.

The instant case is quite distinguishable from *Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972) ("*Ar-*

[3] Pub. L. 97-320, Title IV, § 402, Oct. 15, 1982, 96 Stat. 1510.

nold Tours") where the court held that a bank should not be permitted to conduct a travel agency business as part of the business of banking.[4] The key to the *Arnold Tours* ruling was the inability of the court to find that the rendering of travel agency services was "germane to the financial operations of the bank in the exercise of its express powers." *Id.* at 433.

The Retirement CD is clearly a financial product whose primary attributes are grounded in the Bank's expressly authorized powers. While somewhat novel in its approach to determining interest on deposits funds by providing customers, *inter alia*, with fixed periodic lifetime payment, the Retirement CD nonetheless represents fundamentally a bank authorized product. In recent years, national banks have responded to changing customer needs and market forces by offering a range of innovative bank deposit related instruments. Some deposit instruments have had interest rates tied to various indices such as college tuition costs or stock market performance. In OCC Dec. No. 87-1093, the Comptroller permitted the Chase Manhattan Bank and its affiliate banks to offer a new, non-transferable time deposit account known as the Market Index Investment Deposit Account ("MII"). The MII pays interest at a rate based in part upon changes in the Standard & Poor's 500 Composite Stock Index.[5] The OCC noted that Chase has the express power to offer the MII, and "to pay interest on time deposits according to market conditions, in order to remain competitive with savings alternatives such as money market mutual funds. . . based on any index or standard selected by the bank." *Id.* at 4. The decision also approved Chase's purchase of stock index futures to reduce, or "hedge," its interest rate exposure. On this latter issue the OCC noted that hedging its exposure—

> is an integral adjunct to the bank's deposit-taking activity and is incidental to this power and the business of banking under 12 U.S.C. 24(Seventh). The "incidental powers" clause of this section has been flexibly construed by the courts and the OCC in recognition of the fact that the business of banking is continually changing and evolving.[6]

Like the "college-CD" and "Chase indexed CD" which are deposit products intentionally structured to meet specific customer funding needs, the Retirement CD is structured to provide customers with a return on their deposit to meet retirement needs. This structure remains consistent with the express powers of banks to act as deposit takers and to enter into contracts, and with its authorizations to fund its operations and incur liabilities. The creation of new instruments and services under express or incidental banking powers has been permitted over and over again by the OCC.[7] Moreover, adjustments and refinements of core bank products - designed to accommodate the needs of Bank customers - are clearly permissible as incidental to the business of banking. *Id.*

Over the life of the Retirement CD, the depositor will receive a return of the deposit, plus interest. The timing

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[4]*Arnold Tours* is the leading case in a line of decisions which have concluded that § 24 (Seventh) grants only five expressly enumerated powers and such incidental powers as are "convenient or useful" for performing those five powers. Taken literally, the wording of this test seems to follow a narrow view of the bank powers clause, however, closer review of these cases shows that the reasoning followed is consistent with the historical, broad interpretation of the business of banking. The OCC has rejected a narrow view of the business of banking. For a full discussion of *Arnold Tours* and the OCC's position on the case, *see*. OCC Letter No. Letter No. 494 (December 20, 1989) reprinted in [1989 - 1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

A recent decision of the Fifth Circuit Court of Appeals suggests in dicta a narrow interpretation of the "incidental powers" clause, restricting banks to activities "necessary" to carry out the business of banking. *Variable Annuity Life Ins. Co. v. Clarke*, 998 F.2d 1295 (5th Cir. 1993); *reh'g denied*, 13 F.3d 833 (5th Cir. 1994); *petition for cert. filed*, April 13, 1994 ("*VALIC*"). In our view, this interpretation is seriously flawed. An overriding failing of the opinion was the lack of appropriate deference accorded the views of the agency responsible for interpreting this statute in accordance with *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Moreover, the standard articulated in the VALIC opinion is contrary to longstanding, well established precedent finding that banks may engage in a far broader range of banking activities that resemble or relate to traditional banking activities so that banks may engage in new forms of conducting the business of banking activities so that banks may engage in new forms of conducting the business of banking in response to changing markets and technologies. *See generally*, OCC Letter No. Letter No. 494 (December 20, 1989) reprinted in [1989 - 1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083. The VALIC standard would severely curtail needed and appropriate banking services and may be subject to further review. Notwithstanding the foregoing, we view the instant case as the exercise by the Bank of its express authorizations to receive deposits and enter into contracts, coupled with its powers to incur liabilities and fund its operations.

[5]On April 21, 1987, the Investment Company Institute brought suit in the U.S. District Court for the District of Columbia against Chase and the OCC seeking to enjoin the bank from offering the MII and directing the OCC to withdraw its approval. The ICI claimed that the MII violated the Glass-Steagall Act, 12 U.S.C. 24(Seventh), 377, 378 and 78, and the Financial Institutions Supervisory Act, 12 U.S.C. 1818(b)(1982) (Civil Action No. 87-1093, D.D.C.). The case is still pending.

[6]*Id.* at 4.

[7]*See, e.g.*, OCC Letter No. 331 (April 4, 1985), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,501 (variable annuities), OCC Letter No. 271 (September 21, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,435 (real estate loans and equity interests), OCC Letter No. 387 (June 22, 1987) *reprinted in* Fed. banking L. Rep. (CCH) ¶ 85,611 (real estate loans); OCC Letter No. 326 (January 17, 1985), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,496 (options), OCC Letter No. 356 (January 7, 1986), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,526 (agricultural and metal futures used for hedging), OCC Letter No. 357 (February 26, 1986), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,527 options on financial instruments and on financial futures), OCC Letter No. 365 (August 1, 1986), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,535 (financial futures).

of these receipts calls for up to two-thirds of the maturity balance to be distributed to the depositor at maturity, leaving the remainder as an undistributed maturity balance. The undistributed maturity balance plus an interest factor calculated on the maturity date, is disbursed in the form of lifetime periodic amounts. Should the depositor continue to live after he has received a return of the maturity balance through the periodic amounts, he will continue to receive distributions. These additional distributions represent nothing more than additional interest paid over the life of the Retirement CD. Viewed properly as a single financial product over the full life of the Retirement CD, from initial deposit until final periodic lifetime payment, the total return on the deposited amounts is represented by the sum of (i) interest accrued until maturity (ii) the portion of the periodic amounts which is allocable to interest, plus (iii) those periodic amounts, if any, that are received by the depositor after he has received a return of the maturity balance.

The Retirement CD also contains attributes of a bank liability utilized in the ordinary course of the Bank's business to fund its operations. The form of the liability is a financial instrument sold to customer which contains the characteristics of an ordinary deposit combined with other permissible financial attributes. The timing and calculation of the market return is based in part on the life expectancy of the customer, as calculated at the product's maturity. Simply stated, as with any financial liability, the Retirement CD involves no more than the receipt of customer funds by the Bank in exchange for the payment of a market return to the customer. This flexible form of financing is within the Bank's authorized power to fund its activities through borrowings.

The Bank's Retirement CD simply allows the Bank to offer to its customers, in combination with its other banking related products, the traditional financial advantages normally associated with the business of banking. The product offers Bank customers the opportunity to obtain a return on their funds, structured to accommodate their retirement needs. Market restraints will require that the rate of return on the Retirement CD, when considered in light of the payout structure, is competitive with the market rates of return for other similar financial products, such as traditional bank deposit accounts, bank borrowings, and bank securities offerings. The Retirement CD is a logical outgrowth of the Bank's business mandate which, as with any bank, is to offer its customers competitive and innovative financial products. Through the product, the Bank will be able potentially to reach additional customers and offer current customers an enhanced array of bank products.

The Retirement CD is a natural response to customer demands that their banks offer more diversified alternatives from which they may choose to place their funds. As noted above, bank deposit products already exist to help customers fund college tuition costs and obtain returns competitive with the stock market. Much like the proliferation of IRA accounts and other related deferred compensation products, the Retirement CD is merely a reaction by the Bank as part of its business to create a specially structured bank product intended to meet customer financial needs, with an emphasis on those related to retirement.

Whether the product is characterized as a deposit account, financial contract, bank borrowing or other type of bank product, it remains a financial product which may be offered by the Bank as part of the business of banking. Simply combining activities that fall under the Bank's express and other authority does not affect the underlying ability of the Bank to engage in these activities. In summary, the OCC finds offering the Retirement CD to be authorized under the express powers granted the Bank to receive deposits and enter into contracts, coupled with its powers to incur liabilities, and fund its operations in conducting the business of banking.

III. Conditions

The OCC has no objection to the Bank proceeding with its plans to market and offer the Retirement CD, provided that the Bank complies with the following conditions requisite to the safe and sound operation of this program.

1. The Bank should take appropriate steps to deal with the risks it will undertake in connection with the Retirement CD. In particular, we note that the Bank assumes the risk of paying interest throughout the life of each depositor even in situations where the maturity balance becomes exhausted. The Bank's business plan should indicate in detail how it plans to mitigate this risk as well as the other risks, and consideration should be given to purchasing commercially available annuities from insurance companies to fund the Bank's payment obligations.

2. The Bank should plan for the impact that fluctuations in interest rates will have on its interest rate spread. We note that the product contains an initial fixed rate period of from one to five years, after which the interest rate can be adjusted in accordance with the Bank's cost of funds, but not below a floor of 3

percent. A significant decline in interest rates could reduce or eliminate any spread between the interest rate payable on this product and the interest received on corresponding assets.

3. The Bank must adequately manage its funding sources for the Retirement CD, considering the financial risks associated with the product. The Bank should avoid inadequate matching of funding sources which could result in the unplanned sale of investments in managing interest rate or liquidity risk. This could result in the reclassification of investments as held for sale, the required use of market value accounting and a concomitant decrease in the Bank's capital.

4. The Bank's board of directors should take steps to assure that appropriate accounting standards are followed. Selection of an accounting firm with substantial expertise in the accounting issues associated with the product will be particularly important. We note that the need for specialized accounting expertise has been recognized in the past by the Bank in situations where it has utilized the services of a major accounting firm for specialized reviews.

5. The design and implementation of adequate product controls and systems will be necessary to enable the Bank to mitigate the risks associated with the product. In particular, we note the importance of adequate planning for the use of funds generated from the product; accurate estimation of product payouts; and proper design of internal controls.

6. The Bank should take all necessary steps to assure that representations to customers concerning the FDIC insured status of the Retirement CD are fair and accurate, and that any limitations on the insurance status of the product are conspicuously indicated. In this regard, the Bank should obtain an opinion from the FDIC that it will treat the Retirement CD as an insured product before representing that this product is so insured.

7. We call your attention to the Interagency Statement on retail Sales of Nondeposit Investment products, NR 94-21 (February 17, 1994), which contains guidelines for insured depository institutions engaged in the sale of nondeposit investment products, including mutual funds and annuities. In the event the FDIC determines that all or a portion of the Retirement CD is not covered by FDIC insurance, the guidance provided in the Interagency Statement with regard to nondeposit investment products should be followed in structuring suitable Bank policies and procedures with respect to the manner in which the product is offered and sold to customers.

8. Use of the term "guaranteed" as applied to the Retirement CD may be misleading, and may cause customers to confuse the "guarantee" with FDIC insurance. Some phrases as are currently included in the Bank's promotional materials, such as "bank guaranteed monthly payments for life" may be misconstrued by the public as a FDIC guarantee, especially when the term "guarantee" precedes or follows statements about FDIC insurance. In addition, the claim that the CD is "guaranteed" by the Bank is redundant since the Bank is the obligor on the instrument meaning, that the Bank's guaranteed does not accord the customer any further rights or impose on the Bank any additional obligations. Thus, we strongly urge against use of the term "guaranteed" in promotional materials.

9. The Bank should carefully review representations it plans to make concerning the tax treatment of the Retirement CD to customers. In the event the Bank plans to proceed without obtaining a revenue ruling from the Internal Revenue Service, it should assure its disclosure materials fully inform customers of the risks associated with the Bank's tax position. The distinction between an opinion of counsel and a revenue ruling should also be clearly disclosed.

10. If an early withdrawal by a customer will result in a substantial negative tax impact, this information should be prominently displayed in the Bank's promotional materials. In addition, the promotional materials should contain a full explanation of the tax impact a prepayment could have if forced on customers by the FDIC acting as receiver or conservator for the Bank and if customers elect not to utilize a rollover option.

11. We note the applicability of the requirements imposed by 12 U.S.C. 4301 *et seq.* and 12 CFR 230 *et seq.* ("Truth in Savings") which mandate among other elements, disclosure that the product's interest rate and annual percentage yield ("APY") may change; the

method used to determine the interest rate; the frequency with which the interest rate may change; and limits, if any on the amount the interest rate may change. 12 CFR 230.4(b)(1)(ii). Additional disclosures are required concerning the penalty for early withdrawal, including that a penalty will or may be imposed for early withdrawal, how it is calculated, and the conditions for its assessment. 12 CFR 230.4(b)(6)(ii). We note that the cover letter in the draft promotional materials includes a statement that there are substantial penalties for early withdrawal, as well as a reference to a more detailed explanation of the penalties elsewhere in the materials. However, we believe that the disclosure of the existence of these penalties should be more prominently displayed.

12. As a result of the inherent complexities present with the product, we are particularly concerned that the Bank clearly disclose to prospective and actual customers the product's mechanics and economics. In particular, the promotional materials should clearly explain the way in which the refund feature is calculated. The materials should specifically note that if a depositor dies before receiving distributions equal to the maturity balance, the depositor and his beneficiaries will receive the difference between the maturity balance and the payments received to date. In effect, if this happens, the depositor will not receive any interest on the maturity balance during the payment phase. The impact of this feature we believe is significant enough to warrant conspicuous disclosure on the cover page of the promotional materials. We believe additional disclosures should clearly explain that the periodic lifetime payment amount will be computed on maturity, and will remain fixed throughout the remainder of the customer's life; that the amount in the customer's account at maturity is the dollar amount used for computing the amount of periodic withdrawals; and the manner in which the periodic amounts are determined including how the applicable interest rate is selected.

13. A significant risk associated with the Retirement CD stems from the fact that once the fixed interest rate period expires, the Bank may, in accordance with its cost of funds, adjust the interest rate (but not below the minimum rate) as often as it wishes. This feature of the product may be especially susceptible to confusion on the part of depositors familiar with traditional deposit products. The Bank should take appropriate steps to ensure that customers understand this feature. The risks associated with this feature are significant enough to justify disclosure on the cover page of the promotional materials and elsewhere as appropriate.

14. We note that the Bank expects that most if not all deposits taken under the Retirement CD will come through the mail from depositors located throughout the U.S.A. However, to the extent the Bank engages in sales on its premises, we believe that the unique features of this product requiring disclosure would make it unsuitable for sales in the routine deposit-taking area, such as the teller window. The Bank should arrange for customers to be referred to individuals who are specifically designated and trained to assist customers interested in making a deposit under the Retirement CD. This approach would enable the Bank to ensure that customer questions are answered by personnel who are well-acquainted with the complexities associated with this product.

15. The Bank should implement an appropriate training program for personnel who will be involved in marketing the Retirement CD. The program could be structured to ensure a thorough understanding of the product so that customer questions can be answered properly, and investment risks conveyed adequately.

16. The Bank's training and compensation systems for the product should include safeguards that encourage employees to recommend the Retirement CD only in situations where there are reasonable grounds for believing that the CD is suitable for the particular customer on the basis of information disclosed by the customer. Before making recommendations, employees should make reasonable efforts to obtain tax status, investment objectives, and other information that may be useful, reasonable or necessary to enable the employee to conclude whether the CD is suitable for that customer.

17. The Bank should develop and implement policies and procedures to ensure that its marketing efforts associated with the Retirement CD are in compliance with applicable laws and regulations, safety and soundness, the Bank's internal policies and procedures, and

principles set forth in this letter. The Bank should also provide for a system to monitor customer complaints and their resolution.

You have furnished us with a copy of the Licensing Agreement that was entered into between the Bank and American Deposit Corp., on January 14, 1994 (the "Agreement"). We understand that this Agreement grants the Bank a nonexclusive license to market and sell the Retirement CD throughout the world. The license does not include, however, the right to subcontract or sublicense the marketing and sale of the product *e.g.*, to another bank. Please be advised that the OCC takes no position on the ability of American Deposit Corp. to license this product, or on the proprietary nature of the Retirement CD as it pertains to American Deposit Corp. Moreover, we take no position on whether the Bank or any other depository institution could structure its own CD with attributes similar to those of the product without entering into the Agreement.

If you have any questions on the foregoing, or need any additional information, please feel free to contact the undersigned or Eugene H. Cantor, Senior Attorney, at 202-874-5202.

William P. Bowden, Jr.
Chief Counsel

* * *

650—June 1994

W. Granger Souder
Senior Vice President/General Counsel
Mid Am, Inc.
222 S. Main Street
P.O. Box 428
Bowling Green, Ohio 43402-0428

Re: Notice of Intent from American Community Bank, National Association, Lima, Ohio to acquire Defiance Financial Corporation and its majority owned subsidiary, Defiance HS&L Financial Agency, Inc., as Operating Subsidiaries Control Number 92CE08039

Dear Mr. Souder:

Based on the description set forth in your correspondence and telephone conversations with OCC representatives, the Office of the Comptroller of the Currency ("OCC") approves, subject to the conditions contained in this letter, American Community Bank, National Association's ("American Community" or "the Bank"), Lima, Ohio, plans to acquire Defiance Financial Corporation ("Defiance") and its majority owned insurance subsidiary, Defiance HS&L Financial Agency, Inc. ("Agency") as an operating subsidiary and to sell, as agent, fixed- and variable-rate annuity products from American Community's Lakeview, Ohio branch, a place whose population is less than 5,000.

A. Facts

American Community wishes to acquire Defiance and the Agency from an affiliate, First National Bank Northwest Ohio, Bryan, Ohio ("First National"), to engage in the sale of fixed- and variable-rate annuities. Both banks are owned by Mid Am, Inc. ("Mid Am"), a bank holding company headquartered in Bowling Green, Ohio. The notification was originally filed in the Central District and was subsequently forwarded to the Washington Office for consideration.

The Agency is a licensed Ohio life insurance agency that formerly sold insurance and fixed- and variable-rate annuities. It is presently inactive, but has retained its insurance license to allow it to continue to receive commission income and service fees generated by contracts sold under its former owner, Home Savings and Loan Association, F.A., Defiance, Ohio ("Home S&L"). Mid Am now wishes to revive it so that it may resume the sale of annuities. Concurrently, ownership of Defiance and the Agency is being transferred from First National to American Community as a contribution to surplus. The Agency will be located at the Bank's branch in Lakeview, Ohio, a town of 1,056. After the transfer, the Agency will be renamed "Mid Am Financial Services Agency, Inc."

Defiance is a holding company that will be wholly-owned by American Community. However, the ownership structure of the Agency is unusual. Defiance owns 495 shares (100 percent) of Class B, nonvoting stock of the Agency. All of the Agency's voting stock (Class A, five shares) is owned by an individual, Donald P. Hileman (sometimes referred to as "the individual shareholder"), who is vice president and controller of First National, and also president of Defiance. Apparently, this is the same ownership structure that was employed by Home S&L. Mr. Hileman will continue to own the voting shares of the Agency following the transfer of Defiance to American Community.

B. Discussion

You have proposed this structure in order to comply with state law. Under Ohio insurance law, both fixed- and variable-rate annuities are considered to be insurance and are regulated by the superintendent of insurance. Ohio Rev. Code Ann. § 3911.011 (Anderson

1989). Only a licensed life insurance agent is permitted to sell annuities in Ohio. *Id.* § 3905.21.

Ohio permits a corporation to be licensed as a life insurance agent. However, such a corporation must be organized for the purpose of acting as an insurance agent. *Id.* § 3905.18(C) (Anderson Suppl. 1993). Moreover, Ohio law requires that voting shares of a corporate life insurance agency must be "beneficially owned" by natural persons who are Ohio residents. *Id.* Mr. Hileman has been made the owner of the Agency's voting shares to comply with this requirement, and even though his financial interest is extremely nominal, this apparently satisfies state law. *See* Op. Att'y Gen. No. 88-056 (Ohio 1988) (a corporate insurance agency may be owned as a subsidiary of a bank, but all voting shares must be beneficially owned by natural persons who are residents of Ohio). The Agency will employ another individual who is a licensed life insurance agent to perform the actual sales work.

Since you have voluntarily structured your proposal to comply with Ohio law, there is no need to address issues relating to whether, and to what extent, national banks are required to comply with such state law provisions. We need only decide whether the ownership structure that is proposed is a permissible one for a national bank operating subsidiary.[1]

The OCC's operating subsidiary regulation states that, "[i]n order to qualify as an operating subsidiary, the parent bank must own at least 80 percent of the voting stock of the corporation." 12 CFR 5.34(c). Despite owning only nonvoting shares, the Bank[2] will maintain effective control of the Agency by virtue of a "close corporation agreement" that places numerous restrictions on the individual shareholder. Such an agreement is authorized by Ohio Rev. Code Ann. § 1701.591 (Anderson Supp. 1993).

Through the close corporation agreement with the individual shareholder, American Community will have the indicia of ownership normally associated with voting stock. Among other things, this agreement between Defiance, the Agency, and Mr. Hileman, dated March 20, 1989:

- forbids Mr. Hileman or his estate to transfer his shares without the permission of Defiance (*i.e.*, the Bank), and gives Defiance the right to choose the transferee;
- requires any transferee to be bound by the agreement;
- prohibits issuing new shares of either class of stock without Defiance's consent, and if new shares are issued, requires the new shareholders to be bound by the agreement;
- provides that the Agency may not be sold, liquidated, or merged without Defiance's consent; and
- provides that the Agency shall have no board of directors, which therefore prevents the individual shareholder from controlling the board.

Mr. Hileman, in addition to being the individual shareholder of the Agency, is also the president of Defiance and manager of the Agency. He will therefore be a subordinate of the Bank in those capacities, which will give the Bank complete control over the daily management of the business. In the event of a disagreement between Mr. Hileman and the Bank over the operation of the Agency, you have informed us that Ohio is an "at will" employment state, and Mr. Hileman has no employment contract.[3] It therefore appears that the Bank would have the right to reassign or discharge him in the event that he failed to manage the Agency in accordance with the bank's instructions. If Mr. Hileman's employment ceases for any reason, voluntary or involuntary, or if he is permanently disabled, then under section IV of the close corporation agreement the Bank may designate a natural person to purchase the voting shares of the Agency, and Mr. Hileman is obligated to sell the shares to that person. Therefore, if his status as manager of the Agency were to terminate under hostile circumstances, it would not be possible for a "power struggle" to arise between him and the Bank.

Finally, under Ohio law, following the transfer the Bank will be able to vote on any amendments to the purpose clause of the Agency's articles of incorporation. Ohio

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[1] There is no question that the activities in which it is proposed the operating subsidiary will engage are permissible. The OCC has held that national banks may sell, as agent, both fixed- and variable-rate annuities. Interpretive Letter No. 331, [1985-1987 Transfer Binder] Fed Banking L. Rep. (CCH) ¶ 85,501 (Apr. 4, 1985) (variable); Interpretive Letter No. 499, [1989-1990 Transfer Binder] Fed. Banking L. Re (CCH) ¶ 83,090 (Feb. 12, 1990 (fixed). While that position has been contested, *Variable Annuity Life Ins. Co. v. Clarke*, 998 F.2d 1295 (5th Cir. 1993), *petition for cert. filed*, 62 U.S.L.W. 3707 (U.S. Apr. 13, 1994) (No. 93-1613), there is no dispute that national banks may engage in such activities in places of under 5,000, as is the case here *Independent Ins. Agents of American, Inc. v. Ludwig*, 997 F.2d 958 (D.C. Cir. 1993)

[2] For the sake of simplicity, I will refer to the Bank as the owners of the nonvoting shares. However, they are actually owned by Defiance, the proposed first-tier operating subsidiary

[3] Telephone conversation between W. Granger Souder and Christopher Manthey, Senior Attorney, Corporate Organization and Resolutions Division (March 10, 1994).

Rev. Code Ann. § 1701.71(B)(7) (Anderson 1992). Thus, the Bank will have the power to ensure that the Agency does not engage in any activities not permissible for national banks.

Since the Bank will have the kind of control over the Agency that normally accompanies the ownership of a majority of a company's voting stock, we will consider the class of stock owned by the Bank to be "voting stock" within the meaning of 12 CFR 5.34. As such, it is a permissible investment for the Bank under 12 U.S.C. 24(Seventh). Since the Bank will own 495 of the 500 shares of Agency stock outstanding, the requirement to own at least 80 percent of the voting stock will be satisfied.

C. Conclusion

For the reasons discussed above, the Bank's proposal is approved subject to the following special conditions:

1. The close corporation agreement must continue in existence. This agreement is crucial to our analysis and the Bank must notify the OCC promptly if the agreement is materially changed, cancelled, or becomes invalid for any reason.

2. The articles of incorporation of the Agency must be amended to limit the subsidiary's activities to the sale of annuities. Any expansion of the activities beyond the sale of annuities requires prior notice to and approval from the OCC pursuant to 12 CFR 5.34.

3. The contribution of Defiance and its subsidiary, the Agency, by First National to the Bank must be accounted for on the basis of the subsidiaries' fair market value, and the transfer of ownership must comply with the requirements of 12 U.S.C. 371c.

The operating subsidiaries are subject to, and must be operated within, the constraints of all national banking laws, rulings and regulations. In particular, the Bank should be mindful of the Interagency Statement on Retail Sales of Nondeposit Investment Products (dated February 15, 1994), which provides guidance to banks and their operating subsidiaries on the sales of retail nondeposit investment products. The OCC expects the operating subsidiaries to comply with the circular as well as applicable national banking laws, rulings and regulations.

Please be advised that all conditions of this approval shall be deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818.

Frank Maguire
Senior Deputy Comptroller
Corporate Activities and Policy Analysis

* * *

Mergers—April 1 to June 30, 1994

Mergers consummated involving two or more nonaffiliated operating national banks

Mergers consummated involving nonaffiliated national banks and savings and loan associations

Mergers consummated involving two or more affiliated operating national banks

Mergers consummated between affiliated national banks and savings and loan associations

Most transactions in this section do not have accompanying decisions. In those cases, the OCC reviewed the competitive effects of the proposals by using its standard procedures for determining whether the transaction has minimal or no adverse competitive effects. The OCC found the proposals satisfied its criteria for transactions that clearly had no or minimal adverse competitive effects. In addition, the Attorney General either filed no report on the proposed transaction or found that the proposal would not have a significantly adverse effect on competition.

* * *

Nonaffiliated Mergers*

NATIONAL BANK OF COMMERCE OF BIRMINGHAM, Birmingham, Alabama, and First American Bank of Pelham, Pelham, Alabama

Names of institutions and type of transaction	*Total assets*
National Bank of Commerce of Birmingham, Birmingham,Alabama (18629), with	$359,080,000
and First American Bank of Pelham, Pelham, Alabama, with	17,951,000
merged April 15, 1994, under charter and title of theformer. The merged bank at date of merger had	375,729,000

* * *

NATIONAL BANK OF TUCSON, Tucson, Arizona, and Zions First National Bank of Arizona, Mesa, Arizona

Names of institutions and type of transaction	*Total assets*
National Bank of Tucson, Tucson, Arizona (21383), with	$516,720,000
and Rio Salado Bank, Tempe, Arizona, with	107,299,000
merged April 29, 1994, under charter and title of the former. The merged bank at date of merger had	624,109,000

* * *

FIRST INTERSTATE BANK OF ARIZONA, NATIONAL ASSOCIATION, Phoenix, Arizona, and Chase Bank of Arizona, Scottsdale, Arizona

Names of institutions and type of transaction	*Total assets*
First Interstate Bank of Arizona, National Association(3728), with	$7,180,610,000
and Chase Bank of Arizona, Scottsdale, Arizona, with	527,259,000
merged April 30, 1994, under charter and titleof the former. The merged bank at date of merger had	7,707,869,000

* * *

COMPTROLLER'S DECISION

On February 8, 1994, application was made to the Office of the Comptroller of the Currency (OCC) for prior authorization to merge Chase Bank of Arizona, Scottsdale, Arizona (Chase Bank) into First Interstate Bank of Arizona, National Association, Phoenix, Arizona (First Interstate), under the charter and the title of the First Interstate Bank of Arizona, National Association. This application was based on an agreement entered into between the proponents on December 16, 1993.

As of December 31, 1993, Chase Bank, a state member bank, had total deposits of $407 million and operated 11 offices. On the same date, First Interstate had total deposits of $6 billion and operated 157 offices. Chase Bank is wholly owned and controlled by Chase Manhattan National Holding Corporation, a multibank holding company.

The relevant geographic market for this proposal is the Phoenix Ranally Metropolitan Area. This is the area where Chase Bank of Arizona operates all of its offices and derive the bulk of its deposits. Within this market, 25 commercial banks and eight thrifts compete for deposits of approximately $21 billion. First Interstate ranks third in market deposits with a share of approximately 18 percent. Chase Bank ranks seventh in market deposits with a share of approximately 2 percent.

Consummation of this transaction would result in First Interstate continuing to rank third in market deposits

Nonaffiliated mergers include the merger, consolidation, or purchase and assumption of nonaffiliated operating banks or savings and loan associations, where the resulting bank is a national bank.

Asset figures for merging institutions are not necessarily as of the date of merger and thus may not sum to the total assets given for the merged bank.

with a shares of approximately 20 percent. While the proposed transaction would eliminate some direct competition in the relevant geographic market, any adverse competitive effects would be mitigated by the presence of a number of other banking alternatives, including some of the largest banking companies in the country. Consequently, consummation of the transaction would not have a significantly adverse effect on competition.

The Bank Merger Act requires the OCC to consider ". . .the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial resources of Chase Bank and First Interstate do not raise concerns that would cause the application to be disapproved. The future prospects of the proponents, individually and combined, are considered favorable and the resulting bank is expected to meet the convenience and needs of the community to be served.

Within the Phoenix market area, there are 25 commercial banks and eight thrifts with close to 500 offices. First Interstate operates 84 offices in the area and plans to add two additional offices as a result of this merger. Because of First Interstate's extensive branch network in that market, customers will continue to be properly served.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities has revealed no evidence that the applicants' records of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act (12 U.S.C. 1828(c)) and find that it will not lessen significantly competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved.

* * *

THE FIRST NATIONAL BANK OF GUNNISON,
Gunnison, Colorado, and Crested Butte State Bank, Crested Butte, Colorado

Names of institutions and type of transaction	*Total assets*
The First National Bank of Gunnison, Gunnison, Colorado (2686), with	$56,578,000
and Crested Butte State Bank, Crested Butte, Colorado, with	32,395,000
merged April 12, 1994, under charter and title of theformer. The merged bank at date of merger had	88,879,000

* * *

COMPTROLLER'S DECISION

On December 9, 1993, application was made to the Office of the Comptroller of the Currency (OCC) for prior authorization to merge Crested Butte State Bank, Crested Butte, Colorado (CBSB), into The First National Bank of Gunnison, Gunnison, Colorado (FNB), under the charter and title of The First National Bank of Gunnison. This application was based on an agreement entered into between the proponents on September 28, 1993.

As of September 30, 1993, CBSB, a state-chartered bank, had total deposits of $30.0 million and operated two offices. CBSB is 100 percent owned and controlled by Crested Butte State Bank Holding Company. On the same date, FNB had total deposits of $50.6 million and operated one office. FNB is 100 percent owned and controlled by First National Bankshares of Gunnison, Inc.

The primary service area for FNB is the area including immediately surrounding Gunnison, Colorado. This is the area where FNB operates its sole office and derives the bulk of its deposits. The primary service area for CBSB, the target bank, is centered approximately thirty miles north of Gunnison, an area including and immediately surrounding Crested Butte, Colorado. While the primary service areas of the merging banks are adjacent, each bank receives only a nominal amount of deposits from the area served by the other bank. This proposal essentially constitutes market expansion for FNB and its consummation would not have significantly adverse effect on competition in any banking market.

The Bank Merger Act requires the OCC to consider "...the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial

resources of FNB and CBSB do not raise concerns that would cause the application to be disapproved. The future prospects of the proponents, individually and combined, are considered favorable, and the resulting bank is expected to meet the convenience and needs of the community to be served. FNB and CBSB offer a full line of banking services, and all products and services presently available at the two banks will continued to be offered by the resulting bank. All of the offices of the two banks will continue to be operated by the resulting bank to provide better service to the customers.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities has revealed no evidence that the applicants' records of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act (12 U.S.C. 1828(c)) and find that it will not lessen significantly competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved.

* * *

THE ROCKY FORD NATIONAL BANK,
Rocky Ford, Colorado, and J.N. Beaty and Company, Bankers, Manzanola, Colorado

Names of institutions and type of transaction	*Total assets*
The Rocky Ford National Bank, Rocky Ford, Colorado (9117), with	$19,805,000
and J.N. Beaty and Company, Bankers, Manzanola, Colorado, with	5,142,000
merged May 16, 1994, under charter and title of the former. The merged bank at date of merger had	24,947,000

* * *

SHAWMUT BANK CONNECTICUT, NATIONAL ASSOCIATION,
Hartford, Connecticut, and Gateway Bank, Norwalk, Connecticut

Names of institutions and type of transaction	*Total assets*
Shawmut Bank Connecticut, National Association, Hartford, Connecticut (1338), with	$13,482,051,000
and Gateway Bank, Norwalk, Connecticut, with	1,281,716,000
merged June 27, 1994, under charter and title of the former. The merged bank at date of merger had	14,763,767,000

* * *

COMPTROLLER'S DECISION

On January 26, 1994, application was made to the Office of the Comptroller of the Currency ("OCC") for prior authorization to merge The Gateway Bank, Norwalk, Connecticut, (hereinafter, "Gateway"), with and into Shawmut Bank Connecticut, National Association, Hartford, Connecticut, (hereinafter, "Shawmut"). This application was based on an agreement entered into between the proponents on February 16, 1994.

As of September 30, 1993, Shawmut had total deposits of $8 billion and operated 123 offices. As of the same date, Gateway had total deposits of $1.2 billion and operated 28 offices. Shawmut is wholly owned and controlled by Hartford National Corporation, which is a wholly owned subsidiary of Shawmut National Corporation. Gateway is a state-chartered savings bank owned by Gateway Financial Corporation.

Within the relevant geographic markets served by the proponents, competition between commercial banks and thrifts, including state-chartered savings banks, is keen. In recent years, state legislation has expanded the powers of thrifts to the point where they compete fully with commercial banks. Therefore, they are treated as direct competitors of commercial banks in the analysis of competition.

There are two relevant geographic markets for this proposal. Shawmut and Gateway both operate in the Bridgeport market and the Fairfield Market.

Within the Bridgeport market, 20 commercial banks and thrifts compete for approximately $7.4 billion in deposits. Shawmut is the third largest depository institution with approximately 10 percent of the market's total deposits. Gateway ranks fourth with approximately 7 percent of total deposits. Upon consummation of this transaction, Shawmut would become the second largest depository institution with approximately 17 percent of the market's deposits. While the proposed transaction would eliminate some direct competition in the Bridgeport market, any adverse

competitive effects would be mitigated by the presence of numerous other banking alternatives.

Within the Fairfield market, 36 commercial banks and thrifts compete for approximately $11 billion in deposits. Shawmut is the fourth largest depository institution with approximately 9 percent of the market's deposits. Gateway ranks fifth with approximately seven percent of the deposits. Upon consummation of this transaction, Shawmut would become the second largest depository in the market with approximately sixteen percent of the market's deposits. While the proposed transaction would eliminate some direct competition in the Fairfield market, any adverse competitive effects would be mitigated by the presence of numerous other banking alternatives.

Accordingly, consummation of the transaction would not have a significantly adverse effect on competition.

The Bank Merger Act requires the OCC to consider "...the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial resources of Shawmut do not raise concerns that would cause the application to be disapproved. The future prospects of the proponents, both individually and combined, are considered favorable.

The resulting bank is expected to meet the convenience and needs of the community to be served. Shawmut currently offers a full line of banking services and there will be no changes in these products and services as a result of the transaction. Upon completion of the merger, customers of Gateway will gain access to Shawmut's much broader range of products and services. These include, among others: a full array of trust services, a variety of commercial lending products, an eligible repository for municipal deposits, and a wide variety of deposit products.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities has revealed no evidence that the applicants' records of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act, [12 U.S.C. 1828(c)] and find that it will not significantly lessen competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved subject to the conditions noted in a separate communication to Shawmut.

* * *

FIRST MERCANTILE NATIONAL BANK,
Longwood, Florida, and Central National Bank, Winter Park, Florida

Names of institutions and type of transaction	*Total assets*
First Mercantile National Bank, Longwood, Florida (21591), with	$59,211,000
and Central National Bank, Winter Park, Florida (21230), with	31,515,000
merged April 29, 1994, under charter and title of the former. The merged bank at date of merger had	96,300,000

* * *

FIRST NATIONAL BANK,
Goodland, Kansas, and The Cheyenne County State Bank, St. Francis, Kansas

Names of institutions and type of transaction	*Total assets*
The First National Bank, Goodland, Kansas (14163), with	$99,300,000
and The Cheyenne County State Bank, St. Francis, Kansas, with	32,920,000
merged April 11, 1994, under charter and title of the former. The merged bank at date of merger had	126,198,000

* * *

BANK IV KANSAS, NATIONAL ASSOCIATION,
Wichita, Kansas, and Emprise Bank, National Association, Hutchinson, Kansas

Names of institutions and type of transaction	*Total assets*
Bank IV Kansas, National Association, Wichita, Kansas (12490), with	$4,931,279,000
and Emprise Bank, National Association, Hutchinson, Kansas (10765), with	259,544,000
merged May 31, 1994, under charter and title of the former. The merged bank at date of merger had	5,157,791,000

* * *

COMPTROLLER'S DECISION

On January 27, 1994, application was made to the Office of the Comptroller of the Currency (OCC) for prior authorization to merge Emprise Bank, National Association, Hutchinson, Kansas 67504 (Emprise) into BANK IV, National Association, Wichita, Kansas 67202 (BANK IV), under the charter and title of BANK IV. This application was based on an agreement entered into between the proponents on January 31, 1994.

As of September 30, 1993, Emprise, a national bank, had total deposits of $234,319 million and operated 8 offices. On the same date, BANK IV had total deposits of $3,726,226 million and operated 86 offices. BANK IV is 100 percent owned and controlled by Fourth Financial Corporation, a multibank holding company.

The relevant geographic market for this proposal is the area including and immediately surrounding the community of Garden City. This is the area where competition between the two banks is direct and immediate. Within this market, five commercial banks and three thrifts compete for approximately $345 million in deposits. BANK IV is the second largest competitor with approximately 25 percent of the market's total deposits. The Garden City branch of Emprise to be acquired ranks fifth with approximately 5 percent of the deposits. Consummation of his proposal would result in BANK IV's market share increasing to approximately 30 percent with BANK IV remaining the second largest competitor. While the proposed transaction would eliminate some direct competition in the relevant geographic market, any significant adverse competitive effects would be mitigated by the presence of a number of other banking alternatives.

Emprise also operates branches in the communities of Hutchinson, Iuka, Lindsborg, Meade and Pratt; however, BANK IV does not actively compete in these markets. Therefore, consummation of this transaction would result in the replacement of one competitor by another in these markets.

Accordingly, consummation of this transaction would not have a significantly adverse effect on competition.

The Bank Merger Act requires the OCC to consider "...the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial resources of BANK IV and Emprise do not raise concerns that would cause the application to be disapproved. The future prospects of the proponents, individually and combined, are considered favorable. The resulting bank is expected to meet the convenience and needs of the community to be served. BANK IV will continue to operate all existing facilities of both banks. BANK IV offers a wide variety of products and services, which meet or exceed those currently offered by Emprise. Since no branches of either facility will close, no customer inconvenience is anticipated. Additionally, after this merger, existing customers of Emprise will be able to have their banking needs met at any of BIV's 86 locations throughout Kansas. They will also have expanded products and services.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities has revealed no evidence that the applicants' records of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act (12 U.S.C. 1828(c)) and find that it will not lessen significantly competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved.

* * *

PREMIER BANK, NATIONAL ASSOCIATION,
Baton Rouge, Louisiana, and National Bank of Commerce of Lake Charles, Lake Charles, Louisiana

Names of institutions and type of transaction	Total assets
Premier Bank, National Association, Baton Rouge, Louisiana (13655), with	$4,111,632,000
and National Bank of Commerce of Lake Charles, Lake Charles, Louisiana (17663), with	84,847,000
merged April 30, 1994, under charter and title of the former. The merged bank at date of merger had	4,196,479,000

* * *

PREMIER BANK, NATIONAL ASSOCIATION,
Baton Rouge, Louisiana, and Ruston State Bank and Trust Company, Ruston, Louisiana, and Heritage Bank of Natchitoches, Natchitoches, Louisiana, and Heritage Bank of Morehouse, Bastrop, Louisiana, and The D'Arbonne Bank and Trust Company, Farmerville, Louisiana

Names of institutions and type of transaction	Total assets
Premier Bank, National Association, Baton Rouge, Louisiana (13655), with	$4,212,360,000
and Ruston State Bank and Trust Company, Ruston, Louisiana, with	223,025,000
and Heritage Bank of Natchitoches, Louisiana, with	82,443,000
and Heritage Bank of Morehouse, Bastrop, Louisiana, with	92,133,000
and The D'Arbonne Bank and Trust Company, Farmerville, Louisiana, with	41,620,000
merged June 24, 1994, under charter 13655 and title Premier Bank, National Association.	
The merged bank at date of merger had	4,730,798,000

* * *

SHAWMUT BANK, NATIONAL ASSOCIATION,
Boston, Massachusetts, and Peoples Savings Bank, Worcester, Massachusetts

Names of institutions and type of transaction	Total assets
Shawmut Bank, National Association, Boston, Massachusetts (15509), with	$13,409,650,000
and Peoples Savings Bank, Worcester, Massachusetts, with	896,805,000
merged May 23, 1994, under charter and title of the former. The merged bank at date of merger had	14,307,217,000

* * *

COMPTROLLER'S DECISION

On October 7, 1993, application was made to the Office of the Comptroller of the Currency (OCC) for prior authorization to merge Peoples Savings Bank, Worcester, Massachusetts (hereafter "Peoples") with and into Shawmut Bank, National Association, Boston, Massachusetts (hereafter "Shawmut"). The application is based on an Agreement and Plan of Merger dated as of August 26, 1993, and a Subsidiary Agreement and Plan of Merger dated as of October 21, 1993.

As of June 30, 1993, Peoples, a state-chartered BIF insured stock savings bank, had total deposits of $808 million and operated 23 offices. On the same date, Shawmut had total deposits of $13.4 billion and operated 142 offices. The acquiring bank is a wholly-owned subsidiary of Shawmut Corporation and is indirectly owned and controlled by Shawmut National Corporation, a multi-bank holding company with dual headquarters in Hartford, Connecticut, and Boston, Massachusetts. Peoples is wholly-owned by Peoples Bancorp of Worcester, Inc.

There are three relevant geographic markets for this proposal. These are the areas where the effect of this transaction on competition would be direct and immediate. The three relevant geographic markets, as defined by the Federal Reserve Bank of Boston, as identified below, with basic market structure data listed for each.

Boston Market. Within this market, over 100 financial institutions compete for approximately $81 billion in deposits. Shawmut is the third largest depository institution with approximately 9 percent of the market's deposits. Peoples operates six branches, but does not rank in the top fifty dispository institutions, having less than one half of one percent of the market's deposit. Upon consummation of this transaction, Shawmut will remain the third largest depository institution in the market with approximately nine percent of the market's deposits. While the proposed transaction would eliminate some direct competition in the relevant geographic market, Peoples is not a major competitor in the Boston market and numerous other banking alternatives exist to mitigate any adverse competitive effects.

Worcester Market. Within this market, 10 commercial banks and twenty-one thrift institutions compete for approximately $5 billion in deposits. Shawmut and Peoples are the third and fourth largest depository in-

stitutions in the market with each holding approximately 11 percent of the market's total deposits. Upon consummation of this transaction, Shawmut would be the largest depository institution in the market with approximately 22 percent of the market's deposits. While the proposed transaction would eliminate some direct competition in the relevant geographic market, any adverse competitive effects would be mitigated by the presence of numerous other banking alternatives, including a subsidiary of one of the largest banking companies in the country and branches of several regional banks.

Fitchburg-Leominster Market. Within this market, five commercial banks and five thrift institutions compete for approximately $800 million in deposits. Shawmut is the seventh largest depository institution with approximately 6 percent of the market's total deposits. Peoples ranks third with approximately 15 percent of the deposits. Upon consummation of this transaction, Shawmut would be the largest depository institution in the market with approximately 21 percent of the market's deposits. While the proposed transaction would eliminate some direct competition in the relevant geographic market, any adverse competitive effects would be mitigated by the presence of a number of other banking alternatives, including subsidiaries of three large banking companies.

Accordingly, consummation of this proposal will not have a significantly adverse effect on competition in any of the relevant geographic markets.

The Bank Merger Act requires the OCC to consider "...the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial resources of Peoples and Shawmut do not raise concerns that would cause the application to be disapproved. The future prospects of the proponents, individually and combined, are considered favorable and the resulting bank is expected to meet the needs and convenience of the communities to be served. Shawmut currently offers a full line of banking services and there will be no changes in the products or services offered as a result of the transaction. Customers of Peoples will benefit from Shawmut's statewise banking network as well as trust services and an expanded range of investment services and loan products. Additionally, no branches are expected to be closed in conjunction with this merger.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities has revealed no evidence that the applicants' record of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act [12 U.S.C. 1828(c)] and find that it will not significantly lessen competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved, subject to the conditions noted in a separate communication to Shawmut.

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THE FISHKILL NATIONAL BANK AND TRUST COMPANY,
Poughkeepsie, New York, and The First National Bank of Amenia, Amenia, New York

Names of institutions and type of transaction	*Total assets*
The Fishkill National Bank and Trust Company, Poughkeepsie, New York (35), with	$296,290,000
and The First National Bank of Amenia, Amenia, New York (706), with	15,439,000
merged April 8, 1994, under charter and title of the former. The merged bank at date of merger had	310,290,000

* * *

THE SUFFOLK COUNTY NATIONAL BANK OF RIVERHEAD,
Riverhead, New York, and The Bank of the Hamptons, National Association, South Hampton, New York

Names of institutions and type of transaction	*Total assets*
The Suffolk County National Bank of Riverhead, Riverhead, New York (4230), with	$616,803,000
and The Bank of the Hamptons, National Association, South Hampton, New York (15464), with	165,014,000
merged April 11, 1994, under charter and title of the former. The merged bank at date of merger had	780,902,000

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FIRST FIDELITY BANK, NATIONAL ASSOCIATION, NEW YORK,
Riverdale, New York, and The Savings Bank of Rockland County, Spring Valley, New York

Names of institutions and type of transaction	Total assets
First Fidelity Bank, National Association, New York, Riverdale, New York (22558), with	$990,982,000
and The Savings Bank of Rockland County, Spring Valley, New York, with	185,411,000
merged May 12, 1994, under charter and title of the former. The merged bank at date of merger had	1,176,393,000

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MID-AMERICAN NATIONAL BANK AND TRUST COMPANY,
Bowling Green, Ohio, and Farmers Savings Bank, Northwood, Ohio

Names of institutions and type of transaction	Total assets
Mid-American National Bank and Trust Company, Bowling Green, Ohio (15416), with	$703,941,000
and Farmers Savings Bank, Northwood, Ohio, with	65,389,000
merged June 4, 1994, under charter and title of the former. The merged bank at date of merger had	769,330,000

* * *

BANK OF OKLAHOMA, NATIONAL ASSOCIATION,
Tulsa, Oklahoma, and Plaza National Bank of Bartlesville, Bartlesville, Oklahoma

Names of institutions and type of transaction	Total assets
Bank of Oklahoma, National Association, Tulsa, Oklahoma (13679), with	$2,911,676,000
and Plaza National Bank of Bartlesville, Bartlesville, Oklahoma (15177), with	92,877,000
merged May 2, 1994, under charter and title of the former. The merged bank at date of merger had	2,995,455,000

* * *

THE FROST NATIONAL BANK OF SAN ANTONIO,
San Antonio, Texas, and Texas Commerce Bank—Corpus Christi, National Association, Corpus Christi, Texas

Names of institutions and type of transaction	Total assets
The Frost National Bank of San Antonio, San Antonio, Texas (5179), with	$2,876,932,000
and Texas Commerce Bank—Corpus Christi, National Association, Corpus Christi, Texas (14988), with	173,852,000
merged April 14, 1994, under charter and title of the former. The merged bank at date of merger had	3,053,031,000

* * *

TEXAS COMMERCE BANK, NATIONAL ASSOCIATION,
Houston, Texas, and Cullen/Frost Bank of Dallas, National Association, Dallas, Texas

Names of institutions and type of transaction	Total assets
Texas Commerce Bank, National Association, Houston, Texas (10225), with	$20,818,712,000
and Cullen/Frost Bank of Dallas, National Association, Dallas, Texas (15280), with	162,256,000
merged April 14, 1994, under charter and title of the former. The merged bank at date of merger had	20,979,027,000

* * *

FIRST INTERSTATE BANK OF TEXAS, NATIONAL ASSOCIATION,
Houston, Texas, and The Bank of the West, Austin, Texas

Names of institutions and type of transaction	Total assets
First Interstate Bank of Texas, National Association, Houston, Texas (17612), with	$5,497,707,000
and The Bank of the West, Austin, Texas, with	244,359,000
merged April 29 under charter and title of the former. The merged bank at date of merger had	5,731,920,000

* * *

PEOPLES NATIONAL BANK,
McKinney, Texas, and United Bank and Trust, Dallas, Texas

Names of institutions and type of transaction	*Total assets*
Peoples National Bank, McKinney, Texas (20420), with	$8,253,000
and United Bank and Trust, Dallas, Texas, with	50,636,000
merged May 31, 1994, under charter 20420 and title United Bank and Trust, National Association.	
The merged bank at date of merger had	58,640,000

* * *

SURETY BANK, NATIONAL ASSOCIATION,
Lufkin, Texas, and The Farmers Guaranty State Bank of Kennard, Kennard, Texas

Names of institutions and type of transaction	*Total assets*
Surety Bank, National Association, Lufkin, Texas (15187), with	$48,586,000
and The Farmers Guaranty State Bank of Kennard, Kennard, Texas, with	15,345,000
merged May 31, 1994, under charter and title of the former. The merged bank at date of merger had	63,902,000

* * *

FIRST INTERSTATE BANK OF TEXAS, NATIONAL ASSOCIATION,
Houston, Texas, and Mesquite National Bank, Mesquite, Texas

Names of institutions and type of transaction	*Total assets*
First Interstate Bank of Texas, National Association, Houston, Texas (17612), with	$5,732,060,000
and Mesquite National Bank, Mesquite, Texas (17970),with	45,892,000
merged May 31, 1994 under charter and title of the former. The merged bank at date of merger had	5,775,110,000

* * *

BANK ONE UTAH, NATIONAL ASSOCIATION,
Salt Lake City, Utah, and Capital City Bank, Salt Lake City, Utah

Names of institutions and type of transaction	*Total assets*
Bank One Utah, National Association, Salt Lake City, Utah (18785), with	$860,064,000
and Capital City Bank, Salt Lake City, Utah, with	121,815,000
merged May 2, 1994, under charter and title of the former. The merged bank at date of merger had	981,154,000

* * *

FIRST SECURITY BANK OF UTAH, NATIONAL ASSOCIATION,
Ogden, Utah, and Community First Bank, Clearfield, Utah

Names of institutions and type of transaction	*Total assets*
First Security Bank of Utah, National Association, Ogden, Utah (2597), with	$4,812,699,000
and Community First Bank, Clearfield, Utah, with	79,956,000
merged May 19, 1994, under charter and title of the former. The merged bank at date of merger had	4,892,655,000

* * *

COMPTROLLER'S DECISION

On November 9, 1993, application was made to the Office of the Comptroller of the Currency (OCC) for prior authorization to merge Community First Bank, Clearfield, Utah, (Community First) into First Security Bank of Utah, National Association, Ogden, Utah (First Security), under the charter and the title of First Security Bank of Utah, National Association. The application was based on an agreement entered into between the proponents on October 22, 1993.

As of September 30, 1993, Community First, a state chartered bank, had total deposits of $64 million and operated five offices. On the same date, First Security had total deposits of $4 billion and operated 115 offices. First Security is 99 percent owned and controlled by First Security Corporation, a multibank holding company.

The relevant geographic market for this proposal is the Ogden Ranally Metropolitan Area. This is the area where Community First operates all of its offices and derive the bulk of its deposits. Within this market, ten commercial banks and four thrifts compete for deposits of approximately $1 billion. First Security ranks first in market deposits with a share of approximately 25 percent. Community First ranks eighth in market de-

posits with a share of approximately 5 percent. Consummation of this transaction would result in First Scurity increasing its market share to approximately 30 percent.

While the proposed transaction would eliminate some direct competition in the relevant geographic market, any adverse competitive effects would be mitigated by the presence of a number of other banking alternatives, including some of the largest banking companies in the region. Consequently, consummation of the transaction would not have a significantly adverse effect on competition.

The Bank Merger Act requires the OCC to consider "...the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial resources of Community First and First Security do not raise concerns that would cause the application to be disapproved. The future prospects of the proponents, individually and combined, are considered favorable and the resulting bank is expected to meet the convenience and needs of the communities to be served.

Customers will benefit from First Security's broader array of products and services as well as its extensive branch network.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities has revealed no evidence that the applicants' records of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act (12 U.S.C. 1828(c)) and find that it will not lessen significantly competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved.

* * *

CITIZENS BANK, NATIONAL ASSOCIATION,
Shawano, Wisconsin, and Farmers and Merchants Bank, Greenwood, Wisconsin

Names of institutions and type of transaction	*Total assets*
Citizens Bank, National Association, Shawano, Wisconsin (21289), with	$120,429,000
and Farmers and Merchants Bank, Greenwood, Wisconsin, with	25,360,000
merged May 25, 1994, under charter and title of the former. The merged bank at date of merger had	145,789,000

* * *

Nonaffiliated Mergers (thrift)

UNION NATIONAL BANK OF WICHITA,
Wichita, Kansas, and First Community Federal Savings and Loan Association, Winfield, Kansas

Names of institutions and type of transaction	*Total assets*
Union National Bank of Wichita, Wichita, Kansas (11010), with	$537,127,000
and First Community Federal Savings and Loan Association, Winfield, Kansas, with	169,807,000
merged April 4 under charter and title of the former. The merged bank at date of merger had	701,087,000

* * *

FIRST UNION NATIONAL BANK OF NORTH CAROLINA,
Charlotte, North Carolina, and American Commercial Savings Bank, Monroe, North Carolina

Names of institutions and type of transaction	*Total assets*
First Union National Bank of North Carolina, Charlotte, North Carolina (15650), with	$20,594,000,000
and American Commercial Savings Bank, Monroe, North Carolina, with	242,000,000
merged May 31, 1994, under charter and title of the former. The merged bank at date of merger had	20,836,000,000

* * *

BANK IV OKLAHOMA, NATIONAL ASSOCIATION,
Tulsa, Oklahoma, and Equity Bank for Savings, Federal Association, Oklahoma City, Oklahoma

Names of institutions and type of transaction	*Total assets*
Bank IV Oklahoma, National Association, Tulsa, Oklahoma (18308), with	$1,889,207,000
and Equity Bank for Savings, Federal Association, Oklahoma City, Oklahoma, with	521,608,000
merged May 26 under title and charter of the former. The merged bank at date of merger had	2,408,155,000

* * *

COMPTROLLER'S DECISION

On February 22, 1994, application was made to the Office of the Comptroller of the Currency ("OCC") for prior authorization to merge Equity Bank For Savings, F.A., Oklahoma City, Oklahoma (hereinafter, "Equity Bank"), with and into Bank IV Oklahoma, National Association, Tulsa, Oklahoma (hereinafter, "Bank IV"). This application is based on an agreement finalized between the proponents on February 9, 1994.

As of September 30, 1993, Equity Bank, a SAIF insured, federal savings bank, held total deposits of $350 million and operated 15 offices. As of the same date, Bank IV held total deposits of $1.7 billion and currently operates 38 offices. Equity Bank is wholly owned by Prime Financial Corporation and controlled indirectly by LSB Industries, Inc. Bank IV is wholly owned by Fourth Financial Corporation, a multibank holding company.

There are two relevant geographic markets for this proposal. These are the areas where competition between the two banks is direct and immediate. The two markets are identified below, with basic market structure data listed for each.

Oklahoma City RMA. Within this market, 60 commercial banks and eight thrifts compete for approximately $8 billion in deposits. Bank IV ranks seventeenth with approximately 1 percent of the market's total deposits. Equity Bank ranks ninth with approximately 3 percent of market's deposits. Consummation of this proposal would result in Bank IV's market share increasing to approximately 4 percent. While the proposed transaction would eliminate some direct competition in the relevant geographic market, any adverse competitive effects would be mitigated by the presence of a number of banking alternatives.

Woodward County Banking Market. Within this market, four commercial banks and two thrifts compete for approximately $325 million in deposits. Bank IV is the largest competitor with approximately 31 percent of the market's total deposits. The Equity Bank branch to be acquired ranks fourth with approximately 12 percent of the deposits. Consummation of this proposal would result in Bank IV's market share increasing to approximately forty-three percent. While the proposed transaction would eliminate some direct competition in the relevant geographic market, any adverse competitive effects would be mitigated by the presence of other banking alternatives within the relevant and adjacent markets.

Equity Bank also operates branches in the communities of Beaver, Clinton, Thomas and Sayre; however, Bank IV does not compete in these markets. Therefore, consummation of this transaction would result in the replacement of one competitor with another in these markets.

The Bank Merger Act requires the OCC to consider "...the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served." We find that the financial and managerial resources of both institutions do not raise concerns that would cause the application to be disapproved. Bank IV currently offers a full line of banking services and no changes in its products or services are anticipated as a result of this transaction. Equity Bank's customers will have access to additional products and services. The future prospects of the resulting bank are considered favorable and the resulting bank is expected to meet the convenience and needs of the community to be served.

A review of the record of this application and other information available to the OCC as a result of its regulatory responsibilities, revealed no evidence that the applicants' record of helping to meet the credit needs of their communities, including low- and moderate-income neighborhoods, is less than satisfactory.

We have analyzed this proposal pursuant to the Bank Merger Act [12 U.S.C. 1828(c)] and find that it will not significantly lessen competition in any relevant market. Other factors considered in evaluating this proposal are satisfactory. Accordingly, the application is approved.

* * *

Affiliated Mergers*

NORWEST BANK DENVER, NATIONAL ASSOCIATION,
Denver, Colorado, and First National Bank of Arapahoe County, Aurora, Colorado, and First National Bank of Lakewood, Lakewood, Colorado, and First National Bank of Southeast Denver, Denver, Colorado

Names of institutions and type of transaction	*Total assets*
Norwest Bank Denver, National Association, Denver, Colorado (3269), with	$3,977,841,000
and First National Bank of Arapahoe County, Aurora, Colorado (17798), with	36,650,000
and First National Bank of Lakewood, Lakewood, Colorado (17362), with	63,163,000
and First National Bank of Southeast Denver, Colorado (17757), with	135,733,000
merged June 20, 1994, under charter 3269 and title Norwest Bank Denver, National Association.	
The merged bank at date of merger had	4,213,387,000

* * *

CNB NATIONAL BANK,
Lake City, Florida, and First National Bank of Bradford County, Starke, Florida

Names of institutions and type of transaction	*Total assets*
CNB National Bank, Lake City, Florida (20496), with	$98,349,000
and First National Bank of Bradford County, Starke, Florida (22005), with	15,655,000
merged April 1, 1994, under charter and title of the former. The merged bank at date of merger had	114,004,000

* * *

BANK SOUTH, NATIONAL ASSOCIATION,
Atlanta, Georgia, and The Chattahoochee Bank, Marietta, Georgia

Names of institutions and type of transaction	*Total assets*
Bank South, National Association, Atlanta, Georgia (9617), with	$5,533,292,000
and The Chattahoochee Bank, Marietta, Georgia, with	250,678,000
merged April 7, 1994, under charter and title of the former. The merged bank at date of merger had	5,957,453,000

* * *

BOULEVARD BANK, NATIONAL ASSOCIATION,
Chicago, Illinois, and The First National Bank of Des Plaines, Des Plaines, Illinois, and The National Security Bank of Chicago, Chicago, Illinois, and Citizens National Bank of Downers Grove, Downers Grove, Illinois

Names of institutions and type of transaction	*Total assets*
Boulevard Bank, National Association, Chicago, Illinois (13672), with	$589,999,000
and The First National Bank of Des Plaines, Des Plaines, Illinois (10319), with	526,352,000
and The National Security Bank of Chicago, Chicago, Illinois (13691), with	222,335,000
and Citizens National Bank of Downers Grove, Downers Grove, Illinois (14738), with	163,882,000
merged April 23, 1994, under charter 13672 and title "First Bank, National Association."	
The merged bank at date of merger had	1,473,322,000

* * *

CENTRAL NATIONAL BANK,
Junction City, Kansas, and Central National Bank—Newton, Newton, Kansas, and Central Bank—Herington, Herington, Kansas

Names of institutions and type of transaction	*Total assets*
Central National Bank, Junction City, Kansas (4284), with	$112,624,000
and Central National Bank—Newton, Newton, Kansas (22496), with	64,770,000
and Central Bank—Herington, Herington, Kansas, with	43,314,000
merged April 1, 1994, under charter 4284 and title "Central National Bank." The merged bank at date of merger had	220,708,000

* * *

*Affiliated mergers include mergers, consolidations, and purchase and assumptions of affiliated institutions, where the resulting bank is a national bank

LIBERTY NATIONAL BANK AND TRUST OF WESTERN KENTUCKY,
Hopkinsville, Kentucky, and Liberty National Bank of Madisonville, Madisonville, Kentucky

Names of institutions and type of transaction	Total assets
Liberty National Bank and Trust of Western Kentucky, Hopkinsville, Kentucky (22727), with	$65,000,000
and Liberty National Bank of Madisonville, Madisonville, Kentucky (22521), with	163,000,000
merged April 25, 1994, under charter and title of the former. The merged bank at date of merger had	236,000,000

* * *

MARYLAND NATIONAL BANK,
Baltimore, Maryland, and NationsBank of DC, National Association, Washington, DC

Names of institutions and type of transaction	Total assets
Maryland National Bank, Baltimore, Maryland (17217), with	$14,567,268,000
and NationsBank of DC, National Association, Washington, DC (15013), with	726,101,000
merged April 29, 1994, under charter and title of the former. The merged bank at date of merger had	15,293,369,000

* * *

NATIONSBANK OF MARYLAND, NATIONAL ASSOCIATION,
Bethesda, Maryland, and Maryland National Bank, Baltimore, Maryland

Names of institutions and type of transaction	Total assets
NationsBank of Maryland, National Association, Bethesda, Maryland (22546), with	$4,213,721,000
and Maryland National Bank, Baltimore, Maryland (17217), with	15,293,369,000
merged April 29, 1994, under charter and title of the former. The merged bank at date of merger had	19,492,090,000

* * *

FIRST OF AMERICA BANK—SOUTHEAST MICHIGAN, NATIONAL ASSOCIATION,
Detroit, Michigan, and First of America Bank—Security, Southgate, Michigan

Names of institutions and type of transaction	Total assets
First of America Bank—Southeast Michigan, National Association, Detroit, Michigan (14925), with	$4,041,500,000
and First of America Bank—Security, Southgate, Michigan, with	2,013,100,000
merged May 20, 1994, under charter and title of the former. The merged bank at date of merger had	6,054,500,000

* * *

NORWEST BANK MINNESOTA, NATIONAL ASSOCIATION,
Minneapolis, Minnesota, and Forest Lake State Bank, Forest Lake, Minnesota

Names of institutions and type of transaction	Total assets
Norwest Bank Minnesota, National Association, Minneapolis, Minnesota (2006), with	$15,294,694,000
and Forest Lake State Bank, Forest Lake, Minnesota, with	58,320,000
merged May 6, 1994, under charter and title of the former. The merged bank at date of merger had	15,353,014,000

* * *

THE COMMERCIAL NATIONAL BANK OF AINSWORTH,
Ainsworth, Nebraska, and The First National Bank of Springview, Springview, Nebraska

Names of institutions and type of transaction	Total assets
The Commercial National Bank of Ainsworth, Ainsworth, Nebraska (13139), with	$45,319,000
and The First National Bank of Springview, Springview, Nebraska (13138), with	16,325,000
merged June 20, 1994, under charter and title of the former. The merged bank at date of merger had	61,100,000

* * *

NEW JERSEY NATIONAL BANK,
Ewing Township, New Jersey, and Constellation Bank, National Association, Elizabeth, New Jersey

Names of institutions and type of transaction	*Total assets*
New Jersey National Bank, Ewing Township, New Jersey (1327), with	$4,061,905,000
and Constellation Bank, National Association, Elizabeth, New Jersey (1436), with	2,276,210,000
merged April 29, 1994, under charter and title of the former. The merged bank at date of merger had	6,338,115,000

* * *

NATIONAL CITY BANK, NORTHEAST,
Akron, Ohio, and The Dollar Savings and Trust Company, Youngstown, Ohio, and The Miners and Mechanics Savings and Trust Company, Steubenville, Ohio, and Bank 2000, Minerva, Ohio, and Peoples Banking Company of Martins Ferry, Martins Ferry, Ohio

Names of institutions and type of transaction	*Total assets*
National City Bank, Northeast, Akron, Ohio (17393), with	$1,393,460,000
and The Dollar Savings and Trust Company, Youngtown, Ohio, with	985,649,000
and The Miners and Mechanics Savings and Trust Company, Steubenville, Ohio, with	316,743,000
and Bank 2000, Minerva, Ohio, with	53,988,000
and Peoples Banking Company of Martins Ferry, Martins Ferry, Ohio, with	146,185,000
merged April 30, 1994 under charter 17393 and title "National City Bank, Northeast."	
The merged bank at date of merger had	3,051,509,000

* * *

NORWEST BANK SOUTH DAKOTA,
Sioux Falls, South Dakota, and Farmers State Bank, Winner, South Dakota

Names of institutions and type of transaction	*Total assets*
Norwest Bank South Dakota, Sioux Falls, South Dakota (10592), with	$2,890,201,000
and Farmers State Bank, Winner, South Dakota, with	93,837,000
merged May 16, 1994, under charter and title of the former. The merged bank at date of merger had	2,984,038,000

* * *

UNION PLANTERS NATIONAL BANK,
Memphis, Tennessee, and Tennessee National Bank, Columbia, Tennessee

Names of institutions and type of transaction	*Total assets*
Union Planters National Bank, Memphis, Tennessee (13349), with	$3,471,742,000
and Tennessee National Bank, Columbia, Tennessee (22253), with	93,196,000
merged May 1, 1994, under charter and title of the former. The merged bank at date of merger had	3,387,323,000

* * *

TEXAS COMMERCE TRUST COMPANY—SHERMAN, NATIONAL ASSOCIATION,
Sherman, Texas, and Alliance Trust Company, Dallas, Texas

Names of institutions and type of transaction	*Total assets*
Texas Commerce Trust Company—Sherman, National Association, Sherman, Texas (22701), with	$5,799,000
and Alliance Trust Company, Dallas, Texas, with	713,000
merged June 13, 1994, under charter and title of the former. The merged bank at date of merger had	6,512,000

* * *

HUNTINGTON NATIONAL BANK WEST VIRGINIA,
Morgantown, West Virginia, and Commerce Bank Parkersburg, Parkersburg, West Virginia

Names of institutions and type of transaction	*Total assets*
Huntington National Bank West Virginia, Morgantown, West Virginia (14396), with	$1,101,807,000
and Commerce Bank Parkersburg, Parkersburg, West Virginia, with	121,934,000
merged April 8 under charter and title of the former. The merged bank at date of merger had	1,223,741,000

* * *

ONE VALLEY BANK OF MARTINSBURG, NATIONAL ASSOCIATION,
Martinsburg, West Virginia, and One Valley Bank—East, National Association, Martinsburg, West Virginia

Names of institutions and type of transaction	Total assets
One Valley Bank of Martinsburg, National Association, Martinsburg, West Virginia (4811), with	$149,122,000
and One Valley Bank—East, National Association, Martinsburg, West Virginia (6283), with	182,432,000
merged April 11, 1994, under charter and title of the former. The merged bank at date of merger had	331,554,000

* * *

NATIONAL EXCHANGE BANK AND TRUST,
Fond du Lac, Wisconsin, and State Bank of Cascade, Cascade, Wisconsin

Names of institutions and type of transaction	Total assets
National Exchange Bank and Trust, Fond du Lac, Wisconsin (13879), with	$310,194,000
and State Bank of Cascade, Cascade, Wisconsin, with	13,637,000
merged June 1, 1994, under charter and title of the former. The merged bank at date of merger had	324,600,000

* * *

Affiliated Mergers (thrift)

FIRST BANK, NATIONAL ASSOCIATION,
Minneapolis, Minnesota, and St. Louis Bank for Savings, F.S.B., Duluth, Minnesota

Names of institutions and type of transaction	Total assets
First Bank, National Association, Minneapolis, Minnesota (710), with	$15,227,700,000
and St. Louis Bank for Savings, F.S.B., Duluth, with	200,919,000
merged June 18, 1994, under charter and title of the former. The merged bank at date of merger had	15,442,743,000

* * *

FIRST NATIONAL BANK OF OHIO,
Akron, Ohio, and Great Northern Savings Company, Barberton, Ohio

Names of institutions and type of transaction	Total assets
First National Bank of Ohio, Akron, Ohio (14579), with	$1,850,997,000
and Great Northern Savings Company, Barberton, Ohio, with	385,229,000
merged April 22, 1994, under charter and title of the former. The merged bank at date of merger had	2,236,226,000

* * *

NATIONAL BANK OF THE MAIN LINE,
Wayne, Pennsylvania, and Elwood Federal Savings Bank, Media, Pennsylvania

Names of institutions and type of transaction	Total assets
National Bank of the Main Line, Wayne, Pennsylvania (20221), with	$238,484,000
and Elwood Federal Savings Bank, Media, Pennsylvania, with	249,077,000
merged June 23, 1994 under charter and title of the former. The merged bank at date of merger had	487,561,000

* * *

FIRST INTERSTATE BANK OF TEXAS, NATIONAL ASSOCIATION,
Houston, Texas, and First Interstate Trust Company of Texas, Houston, Texas

Names of institutions and type of transaction	Total assets
First Interstate Bank of Texas, National Association, Houston, Texas (17612), with	$5,364,590,000
and First Interstate Trust Company of Texas, Houston, Texas, with	500,000
merged June 15, 1994, under charter and title of the former. The merged bank at date of merger had	5,364,590,000

* * *

Structure Tables

Changes in the structure of the national banking system, by state, January 1 to June 30, 1994

	In operation January 1, 1994	Organized and opened for business	Merged	Voluntary liquidations	Payouts	12 U.S.C. 214		In operation June 30, 1994
						Converted to non-national institutions	Merged with non-national institutions	
Alabama	50	1	0	0	0	0	0	51
Alaska	4	0	0	0	0	0	0	4
Arizona	14	0	1	0	0	0	0	13
Arkansas	77	1	0	0	0	0	0	78
California	143	0	0	1	2	2	0	138
Colorado	159	0	21	0	0	1	1	136
Connecticut	12	0	0	0	0	0	0	12
Delaware	16	0	0	0	0	0	0	16
District of Columbia	19	0	2	0	0	0	0	17
Florida	132	0	2	0	0	1	3	126
Georgia	74	0	0	0	0	0	0	74
Hawaii	2	0	0	0	0	0	0	2
Idaho	4	0	0	0	0	0	0	4
Illinois	296	0	7	0	0	0	1	288
Indiana	72	0	3	0	0	0	0	69
Iowa	80	1	1	0	0	0	0	80
Kansas	140	1	2	0	0	0	2	137
Kentucky	84	2	5	0	0	1	0	80
Louisiana	41	0	2	0	0	0	0	39
Maine	7	0	0	0	0	0	0	7
Maryland	24	1	1	0	0	0	0	24
Massachusetts	25	0	0	0	0	0	1	24
Michigan	53	0	0	0	0	0	0	53
Minnesota	136	1	1	0	0	0	0	136
Mississippi	27	0	0	0	0	0	0	27
Missouri	72	1	1	0	0	7	2	63
Montana	28	0	0	0	0	0	0	28
Nebraska	104	0	1	0	0	0	0	103
Nevada	9	0	0	0	0	0	1	8
New Hampshire	10	0	0	0	0	0	0	10
New Jersey	41	0	2	0	0	0	1	38
New Mexico	34	0	1	0	0	0	0	33
New York	74	0	4	0	0	1	0	69
North Carolina	14	0	0	0	0	0	0	14
North Dakota	28	0	0	0	0	0	0	28
Ohio	119	2	2	0	0	0	0	119
Oklahoma	126	0	1	1	0	2	1	121
Oregon	7	0	0	0	0	0	0	7
Pennsylvania	137	0	2	0	0	0	1	134
Rhode Island	4	0	0	0	0	0	0	4
South Carolina	27	0	0	0	0	0	0	27
South Dakota	17	1	0	0	0	0	0	18
Tennessee	43	1	2	0	0	1	0	41
Texas	504	5	5	2	0	3	2	497
Utah	8	0	0	0	0	0	0	8
Vermont	10	0	0	0	0	0	0	10
Virginia	42	0	0	1	0	4	0	37
Washington	20	1	0	0	0	0	0	21
West Virginia	61	0	1	0	0	0	0	60
Wisconsin	96	0	1	0	0	0	0	95
Wyoming	21	0	0	0	0	0	0	21
Puerto Rico	1	0	0	0	0	0	0	1
United States	3,348	19	71	5	2	23	16	3,250

The column "organized and opened for business" includes all state banks converted to national banks, all newly formed national banks, and savings and loan associations converted to national banks. The column entitled "merged" includes all mergers, consolidations and purchases and assumptions in which an operating national bank was acquired by another national bank. Also included in this column are immediate FDIC-assisted "merger" transactions. The column entitled "voluntary liquidations" includes only straight liquidations of national banks. No liquidations pursuant to a purchase and assumption transaction are included in this total. Liquidations resulting from purchases and assumptions are included in the "merged" columns. The column entitled "payouts" includes all failed national banks where the FDIC is named receiver and no other depository institution is named as receiver. The column entitled "merged with state banks" includes all mergers, consolidations, and purchases and assumptions where the resulting institution is a state-chartered bank. Also included in this column are immediate FDIC-assisted "merger" transactions where the resulting institution is a state-chartered bank. Nationally chartered bridge banks are not included on this table

Applications for full-service national bank charters, approved and denied, by state, January 1 to June 30, 1994

Title and location of bank	*Approved*	*Denied*
Alabama		
National Bank of the South, Tuscaloosa	May 20	
Arkansas		
Arkansas National Bank, Bentonville	April 4	
Florida		
Cape Coral National Bank, Cape Coral	April 4	
Louisiana		
First National Bank of Crowley, Crowley	March 11	
Maryland		
Sequoia National Bank Maryland, Bethesda	January 28	
Tennessee		
Union Planters Bank of Chattanooga, N.A., Chattanooga	June 16	
Union Planters Bank of Jackson, N.A., Jackson	June 16	
Union Planters Bank of East Tennessee, N.A., Knoxville	June 16	
Union Planters Bank of Middle Tennessee, N.A., Nashville	June 16	
Virginia		
Community National Bank, Pulaski	February 23	

Applications for limited-purpose national bank charters, approved and denied, by state, January 1 to June 30, 1994

Title and location of bank	*Type of bank*	*Approved*	*Denied*
Colorado			
Bank One Colorado Trust Company, N.A., Denver	Trust	February 2	
Delaware			
Whirlpool Financial National Bank, New Castle	Credit card	May 26	
Georgia			
AFBA National Credit Card Bank, Atlanta	Credit card	March 11	
New York			
First Trust of New York, N.A., New York	Trust	June 23	
Texas			
Texas Commerce Trust Company Corpus Christi, N.A., Corpus Christi	Trust	February 18	
Texas Commerce Trust Company, Sherman, N.A., Sherman	Trust	February 18	
Texas Commerce Trust Company, Waco, N.A., Waco	Trust	February 18	
Texas Commerce Trust Company, Wichita Falls, N.A., Wichita Falls	Trust	February 18	
Utah			
Direct Merchants Credit Card Bank, N.A., Salt Lake City	Credit card	June 15	

New full-service national bank charters issued, January 1 to June 30, 1994

Title and location of bank	*Charter number*	*Date opened*
Alabama		
National Bank of the South, Tuscaloosa	22777	May 20
Arkansas		
Arkansas National Bank, Bentonville	22721	June 1
Maryland		
Sequoia National Bank Maryland, Bethesda	22686	January 31
Texas		
Graham National Bank, Graham	22643	January 3
Washington		
Fremont First National Bank, Seattle	22662	May 16

New limited-purpose national bank charters issued, January 1 to June 30, 1994

Title and location of bank	*Charter number*	*Date opened*
South Dakota		
Retailers National Bank, Sioux Falls (credit card)	22549	January 7
Tennessee		
Tandy National Bank, Gray (credit card)	22425	May 11
Texas		
Texas Commerce Trust Company Corpus Christi, N.A., Corpus Christi (trust)	22704	June 10
Texas Commerce Trust Company Waco, N.A., Waco (trust)	22703	June 10
Texas Commerce Trust Company Wichita Falls, Wichita Falls (trust)	22702	June 10
Texas Commerce Trust Company Sherman, N.A., Sherman (trust)	22701	June 10

National banks converted out of the national banking system, January 1 to June 30, 1994

Title and location of bank	*Effective date*	*Total assets*
California		
Merced Bank of Commerce, N.A., Merced (18355)	April 1	91,845,000
Colorado		
Vail National Bank, Vail (16690)	January 24	74,006,000
Florida		
Sun Bank of Lee County, N.A., Fort Myers (17300)	January 4	589,651,000
Missouri		
Mercantile Bank of Stoddard/Bollinger Counties, N.A., Dexter (18164)	May 17	81,867,000
Mercantile Bank of Doniphan, N.A., Doniphan (14658)	May 17	54,476,000
Mercantile Bank of Joplin, N.A., Joplin (13162)	May 17	421,612,000
Mercantile Bank of Monett, N.A., Monett (5973)	June 3	84,541,000
Mercantile Bank of Montgomery City, N.A., Montgomery City (11235)	May 19	43,958,000
Mercantile Bank of St. Joseph, N.A., St. Joseph (6272)	May 24	353,704,000
Mercantile Bank of Trenton, N.A., Trenton (4933)	May 24	84,502,000
New York		
Hudson Valley National Bank, Yonkers (15968)	May 21	—
Oklahoma		
Victory National Bank of Nowata, Nowata (14558)	June 30	25,500,000
First National Bank and Trust Company, Perry (14020)	January 4	71,856,000
Tennessee		
First National Bank of Knoxville, Knoxville (21668)	June 17	92,231,000
Texas		
The First National Bank of Anna, Anna (12867)	February 28	33,963,000
Bank of West, N.A., Odessa (17609)	June 30	—
Heritage National Bank, Red Oak (21010)	January 1	31,000,000
Virginia		
The First National Bank of Emporia, Emporia (8688)	March 7	67,772,000
The Middleburg National Bank, Middleburg (12539)	February 7	120,662,000
The Farmers and Merchants National Bank of Stanley, Stanley (10973)	April 1	71,931,000
The Fauquier National Bank, Warrenton (6126)	June 25	162,077,000

National banks merged out of the national banking system, January 1 to June 30, 1994

Title and location of bank	Charter number	Effective date
Colorado		
Valley Bank, N.A., Brighton	18384	January 27
Florida		
1st Performance National Bank, Jacksonville	22540	January 27
Citizens National Bank of Naples, Naples	18630	May 12
Morgan Trust Company of Florida, N.A., Palm Beach	17214	January 1
Illinois		
The First National Bank of Highland, Highland	6653	March 11
Kansas		
UMB City National Bank of Atchison, Atchison	11405	May 2
UMB Bank Kansas, Overland Park	6311	May 2
Massachusetts		
Suburban National Bank of Arlington, Arlington	15052	December 23, 1993
Missouri		
The First National Bank of Bethany, Bethany	8009	March 21
Nevada		
Continental National Bank, Las Vegas	17624	February 4
New Jersey		
Ocean National Bank, Point Pleasant Beach	5712	June 10
Oklahoma		
The Helena National Bank, Helena	12081	June 10
Pennsylvania		
First Valley Bank, Bethlehem	4204	March 18
Texas		
Texas Bank of Garland, N.A., Garland	18127	April 1
Security Bank, N.A., Houston	20003	May 6

State-chartered banks converted to full-service national banks, January 1 to June 30, 1994

Title and location of bank	*Effective date*	*Total assets*
Iowa		
Boatmen's National Bank Iowa (22681),conversion of Boatmen's Bank of Urbandale, Urbandale	January 1	102,221,000
Kansas		
Commerce Bank, N.A. (22705), conversion of Commerce Bank, Hays	April 14	106,992,000
Kentucky		
Liberty National Bank and Trust Company of Central Kentucky (22700), conversion of Hardin County Bank and Trust, Inc, Radcliff	February 21	60,040,000
Ohio		
Norwest Bank Ohio, N.A. (22697), conversion of Norwest Bank Van Wert, Van Wert	March 1	68,746,000

Nonbanking institutions converted to full-service national banks, January 1 to June 30, 1994

Title and location of bank	*Effective date*	*Total assets*
Kentucky		
Liberty National Bank and Trust Company of Western Kentucky (22727), conversion of First Federal Savings Bank, Hopkinsville	April 25	236,000,000
Minnesota		
St. Louis Bank for Savings, N.A. (22725), conversion of St. Louis Bank for Savings, F.S.B.	April 29	200,919,000
Missouri		
First Missouri National Bank (22706), conversion of First Missouri Federal Savings and Loan Association, Brookfield	April 8	40,834,000
Ohio		
Peoples Bank, N.A. (18821), conversion of Peoples Savings Bank, Ashtabula	April 14	307,854,000

National banks in voluntary liquidation, January 1 to June 30, 1994

Title and location of bank	Charter number	Effective date
California		
Colonial Bank, N.A., Santa Ana	21482	May 12
Oklahoma		
Leadership Bank, N.A.., Oklahoma City	18245	January 5
Texas		
International Bank, N.A., Brownsville	17046	January 3
National Loan Bank, Houston	18557	February 15
Virginia		
Farmers and Merchants National Bank, Hamilton	9861	September 18

Failed national banks paid-out by the Federal Deposit Insurance Corporation, January 1 to June 30, 1994

Title and location of bank	Charter number	Effective date
California		
Mechanics National Bank, Paramount	15478	April 1
Barbary Coast National Bank, San Francisco	21513	May 19

Federal branches and agencies of foreign banks in operation, January 1 to June 30, 1994

	In operation January 1, 1994	*Opened January 1 - June 30*	*Closed January 1 - June 30*	*In operation June 30, 1994*
Federal branches				
California	4	0	0	4
District of Columbia	1	0	0	1
Illinois	1	0	0	1
New York	48	0	0	48
Washington	1	0	0	1
Limited federal branches				
California	9	1	0	10
District of Columbia	2	0	0	2
Illinois	1	0	0	1
New York	5	0	0	5
Federal Agencies				
Florida	1	0	0	1
Total United States	73	1	0	74

Statistical Tables

Page

Assets, liabilities and capital accounts of national banks, June 30, 1993 and June 30, 1994
(Dollar amounts in millions)

	June 30, 1993	June 30, 1994	Change June 30, 1993 - June 30, 1994 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Assets				
Cash and balances due from depository institutions:				
Noninterest-bearing balances and currency and coin	$110,153	$112,527	2,374	1.02
Interest bearing balances	49,626	48,542	−1,084	0.98
Securities not in trading account*	420,881	440,020	19,139	1.05
Federal funds sold and securities purchased under agreements to resell	91,047	84,905	−6,142	0.93
Loans and leases net of unearned income	1,207,473	1,300,391	92,918	1.08
Less allowance for loan and lease losses	32,510	31,301	−1,208	0.96
Less allocated transfer risk reserve	190	4	−186	0.02
Net loans and leases	1,174,774	1,269,086	94,312	1.08
Premises and fixed assets	31,849	32,731	882	1.03
Other real estate owned	14,880	8,405	−6,475	0.56
All other assets**	120,656	189,037	68,381	1.57
Total assets	2,013,865	2,185,253	171,387	1.09
Liabilities				
Deposits:				
Noninterest-bearing deposits in domestic offices	302,866	309,159	6,293	1.02
Interest-bearing deposits in domestic offices	1,026,062	1,014,903	−11,159	0.99
Total domestic deposits	1,328,928	1,324,063	−4,865	1.00
Total foreign deposits	200,025	240,213	40,188	1.20
Total deposits	1,528,953	1,564,275	35,323	1.02
Federal funds purchased and securities sold under agreements to repurchase	155,138	173,955	18,817	1.12
Demand notes issued to the U.S. Treasury	20,057	22,725	2,668	1.13
Other borrowed money	67,842	105,863	38,021	1.56
Subordinated notes and debentures	23,926	24,153	226	1.01
All other liabilities**	61,989	126,055	64,066	2.03
Total liabilities	1,857,905	2,017,026	159,121	1.09
Limited-life preferred stock	1	1	0	NM
Equity Capital				
Perpetual preferred stock	165	122	−43	0.74
Common stock	16,776	16,945	169	1.01
Surplus	69,916	74,480	4,663	1.07
Net undivided profits and capital reserves	69,829	77,381	7,552	1.11
Cumulative foreign currency translation adjustments	−727	−702	25	0.97
Total equity capital	155,959	168,225	12,266	1.08
Total liabilities, limited-life preferred stock, and equity capital	2,013,865	2,185,253	171,387	1.09

NM = Not meaningful
*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.
**Beginning in 1994, trading account assets, which are included in all other assets, are reported on a gross basis, and trading liabilities are reported separately and included in all other liabilities.

Income and expenses of foreign and domestic offices and subsidiaries of national banks, June 30, 1994
(Dollar amounts in millions)

	Consolidated foreign and domestic	*Percent distribution*
Interest income:		
Interest and fee income on loans	$54,793	74.5
Income from lease financing receivables	1,170	1.6
Interest income on balances due from depository institutions	1,582	2.2
Interest and dividend income on securities	12,581	17.1
Interest income from assets held in trading accounts	1,756	2.4
Interest income from federal funds sold and securities purchase agreements to resell	1,642	2.2
Total interest income	73,524	100.0
Interest expense:		
Interest on deposits	21,893	68.0
Expense of federal funds purchased and securities sold under agreements to repurchase	3,106	9.6
Interest on demand notes issued to the U.S. Treasury and on other borrowed money	6,422	20.0
Interest on mortgage indebtedness and obligations under capitalized leases	48	0.1
Interest on notes and debentures subordinated to deposits	721	2.2
Total interest expense	32,189	100.0
Net interest income	41,335	
Provision for loan and lease losses	2,891	
Provision for allocated transfer risk	−10	
Noninterest income:		
Service charges on deposit accounts	4,736	21.3
Other noninterest income	17,472	78.7
Total noninterest income	22,209	100.0
Gains and losses on securities not held in trading accounts	462	
Noninterest expense:		
Salaries and employee benefits	16,967	41.4
Expenses of premises and fixed assets (net of rental income)	5,435	13.3
Other noninterest expense	18,600	45.4
Total noninterest expense	41,003	100.0
Income (loss) before income taxes and extraordinary items and other adjustments*	20,070	
Applicable income taxes	6,835	
Income before extraordinary items and other adjustments	13,210	
Extraordinary items and other adjustments, net of taxes	−35	
Net income	13,175	
Total cash dividends declared**	6,719	
Recoveries credited to allowance for possible loan losses	1,909	
Losses charged to allowance for possible loan losses	4,954	
Net loan losses	3,045	

*The subcomponents of income before taxes and extraordinary items do not add to the reported total because the data are preliminary.
**Banks with assets of less than $100 million report this item only in their December report of income.
Note: Preliminary year-to-date data.

Loans of national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Total loans, gross	Domestic offices: Loans secured by real estate	Domestic offices: Loans to farmers	Domestic offices: Commercial and industrial loans	Domestic offices: Loans to individuals	Domestic offices: Other loans	Total loans at foreign offices
All national banks	$1,303,626	$514,081	$16,009	$282,154	$240,901	$99,808	$150,674
Alabama	13,645	6,236	105	3,805	2,622	877	0
Alaska	1,932	902	0	595	306	122	7
Arizona	15,946	6,004	314	2,016	6,399	1,214	0
Arkansas	6,927	3,646	288	1,228	1,572	193	0
California	148,217	70,479	2,220	22,241	15,074	9,159	29,044
Colorado	13,362	5,931	464	2,286	3,730	951	0
Connecticut	14,299	8,227	3	3,672	1,169	1,229	0
Delaware	21,965	634	5	129	20,906	134	156
District of Columbia	3,843	2,624	0	591	188	228	213
Florida	59,886	34,323	201	8,842	13,292	3,033	196
Georgia	36,811	14,643	141	10,060	9,225	2,742	0
Hawaii	220	143	0	66	9	3	0
Idaho	3,985	1,408	295	611	1,534	137	0
Illinois	52,188	20,218	827	15,864	8,377	4,743	2,160
Indiana	27,593	12,817	388	5,312	7,551	1,524	0
Iowa	9,012	3,187	688	1,744	3,132	261	0
Kansas	7,872	3,255	954	1,741	1,690	232	0
Kentucky	14,139	6,359	145	3,077	3,433	1,124	0
Louisiana	10,964	4,730	116	2,421	3,146	551	0
Maine	1,639	1,046	5	398	155	36	0
Maryland	17,633	9,039	16	3,455	2,508	2,269	346
Massachusetts	40,294	13,086	8	13,808	2,360	2,140	8,893
Michigan	32,009	11,990	102	9,750	6,597	2,481	1,089
Minnesota	27,705	11,612	668	7,646	3,855	3,743	181
Mississippi	5,844	2,797	134	1,261	1,391	261	0
Missouri	18,692	7,711	295	5,478	3,547	1,660	0
Montana	1,969	813	185	334	604	33	0
Nebraska	9,430	3,090	1,442	1,513	3,048	336	0
Nevada	7,451	987	9	205	6,205	45	0
New Hampshire	1,920	700	0	47	1,163	10	0
New Jersey	49,530	27,758	62	10,743	5,711	5,135	122
New Mexico	4,005	2,188	104	568	1,022	123	0
New York	198,047	39,446	227	25,472	11,008	16,402	105,493
North Carolina	44,666	18,497	264	15,043	3,852	5,961	1,049
North Dakota	2,297	997	299	502	447	53	0
Ohio	74,808	28,653	362	16,523	23,765	5,408	96
Oklahoma	9,578	4,272	608	2,489	1,887	321	0
Oregon	12,763	4,010	273	3,990	2,965	1,506	19
Pennsylvania	73,666	30,154	115	24,083	8,858	9,166	1,291
Rhode Island	7,751	3,156	0	3,043	391	1,161	0
South Carolina	14,828	9,048	51	2,372	2,531	826	0
South Dakota	12,187	1,059	481	1,739	8,794	113	0
Tennessee	23,378	11,257	136	6,172	4,361	1,453	0
Texas	71,571	29,712	1,732	21,872	13,103	4,873	278
Utah	6,898	3,273	128	1,156	1,876	465	0
Vermont	1,568	1,029	5	311	182	41	0
Virginia	21,926	10,593	95	4,226	3,979	3,034	0
Washington	21,189	8,088	645	5,879	5,658	901	18
West Virginia	7,289	4,100	12	1,149	1,801	227	0
Wisconsin	16,847	7,519	293	4,325	3,530	1,154	26
Wyoming	902	350	98	175	267	13	0
Puerto Rico	541	288	1	126	124	3	0

Note: Preliminary end-of-quarter data. Zeros indicate amounts of less than $500,000.

Deposits of national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Total demand deposits at domestic offices	*All NOW accounts*	*Money market deposit accounts*	*Large time deposits*	*All other deposits at domestic offices*	*Total deposits at foreign offices*	*Total consolidated deposits*
All national banks	$301,911	$164,505	$269,633	$52,717	$535,296	$240,213	$1,564,275
Alabama	2,808	1,804	2,964	704	6,653	264	15,197
Alaska	874	264	423	133	1,100	0	2,795
Arizona	5,277	2,418	6,214	1,018	6,088	0	21,014
Arkansas	2,044	2,082	1,343	1,246	4,772	0	11,488
California	37,952	15,281	42,597	1,785	42,039	29,236	168,889
Colorado	5,092	3,656	4,145	758	6,540	22	20,212
Connecticut	4,715	2,178	2,829	111	8,303	359	18,495
Delaware	463	141	2,490	998	4,739	509	9,338
District of Columbia	1,710	1,136	2,097	224	1,517	237	6,921
Florida	15,544	9,012	18,367	3,331	29,453	570	76,278
Georgia	8,467	4,911	6,295	1,422	14,739	659	36,493
Hawaii	61	37	33	35	106	0	272
Idaho	645	538	618	275	1,585	0	3,661
Illinois	14,295	7,357	9,325	4,749	28,965	12,179	76,870
Indiana	6,019	4,780	4,502	1,138	14,622	89	31,150
Iowa	1,892	1,674	1,692	535	5,016	0	10,809
Kansas	1,927	2,144	1,950	831	5,570	0	12,422
Kentucky	2,997	2,698	1,745	849	7,222	457	15,967
Louisiana	4,441	2,661	2,947	1,056	8,446	79	19,630
Maine	245	240	201	95	963	0	1,744
Maryland	5,579	2,672	3,935	362	10,216	763	23,527
Massachusetts	8,121	3,682	7,500	248	11,568	9,501	40,620
Michigan	7,842	2,926	7,126	999	16,123	3,503	38,521
Minnesota	7,642	3,744	5,984	657	10,651	891	29,567
Mississippi	1,712	1,484	1,524	861	3,532	0	9,113
Missouri	6,076	3,788	5,450	590	9,553	192	25,649
Montana	496	450	518	116	928	0	2,508
Nebraska	1,890	1,797	1,344	1,588	5,586	0	12,205
Nevada	1,039	621	1,064	352	1,044	0	4,120
New Hampshire	114	127	358	631	764	0	1,994
New Jersey	14,828	8,755	10,013	944	33,250	726	68,516
New Mexico	1,233	1,195	1,035	546	2,546	0	6,555
New York	28,035	6,825	26,981	3,052	27,932	152,093	244,919
North Carolina	8,396	3,545	6,797	871	14,564	12,838	47,009
North Dakota	444	582	425	169	1,360	0	2,980
Ohio	13,958	9,207	9,549	2,084	37,889	6,212	78,899
Oklahoma	3,056	2,649	2,173	1,437	6,551	29	15,896
Oregon	3,343	2,228	2,919	28	4,641	13	13,173
Pennsylvania	16,350	7,421	14,831	2,816	34,318	4,887	80,623
Rhode Island	1,083	608	1,593	208	3,513	1,015	8,020
South Carolina	3,188	2,834	2,798	1,004	6,492	56	16,372
South Dakota	748	583	1,399	849	2,882	0	6,462
Tennessee	5,822	3,904	5,554	1,315	13,429	211	30,235
Texas	24,630	16,356	19,492	6,170	39,341	2,212	108,201
Utah	1,977	1,208	1,450	58	3,367	81	8,140
Vermont	242	253	404	59	808	0	1,765
Virginia	5,170	3,361	4,780	1,867	12,048	0	27,226
Washington	5,887	2,680	6,163	97	6,062	39	20,929
West Virginia	1,422	1,468	783	518	5,674	0	9,866
Wisconsin	3,755	2,083	2,618	781	8,975	292	18,505
Wyoming	290	368	288	144	631	0	1,721
Puerto Rico	77	90	11	0	616	0	793

Note: Preliminary end-of-quarter data. Zeros indicate amounts of less than $500

Interest income of national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Interest and fees on loans	Income from lease financing	Interest due from other depository institutions	Interest and dividends on securities	Interest from trading account assets	Interest from federal funds transactions	Total interest income
All national banks	$54,793	$1,170	$1,582	$12,581	$1,756	$1,642	$73,524
Alabama	518	5	1	148	2	13	686
Alaska	87	0	0	41	0	1	129
Arizona	709	28	1	166	1	13	917
Arkansas	264	1	1	133	0	6	406
California	5,318	144	136	827	219	113	6,757
Colorado	510	5	16	225	0	18	774
Connecticut	500	0	2	263	0	6	771
Delaware	1,376	4	2	40	0	5	1,426
District of Columbia	141	0	8	67	0	17	232
Florida	2,346	6	41	588	0	78	3,059
Georgia	1,383	28	11	263	2	38	1,725
Hawaii	9	0	0	1	0	0	10
Idaho	150	2	0	14	7	2	174
Illinois	1,861	15	150	600	79	142	2,847
Indiana	1,046	25	3	263	0	25	1,361
Iowa	380	1	1	137	0	9	529
Kansas	317	4	2	157	0	9	489
Kentucky	519	12	0	134	0	15	680
Louisiana	448	1	4	277	0	13	743
Maine	62	0	0	10	0	1	73
Maryland	687	7	7	241	1	39	982
Massachusetts	1,574	41	48	295	28	40	2,025
Michigan	1,181	12	24	383	4	25	1,628
Minnesota	990	26	2	209	6	63	1,297
Mississippi	230	0	3	125	0	9	367
Missouri	682	10	3	294	4	38	1,031
Montana	85	0	0	19	0	3	107
Nebraska	436	1	1	108	0	9	554
Nevada	465	1	1	51	0	2	520
New Hampshire	192	0	0	8	0	11	210
New Jersey	1,813	65	27	536	4	63	2,508
New Mexico	161	1	1	74	3	9	249
New York	12,391	388	969	1,429	1,229	285	16,691
North Carolina	1,509	49	25	391	110	108	2,190
North Dakota	90	0	0	28	0	1	120
Ohio	3,132	99	4	605	1	86	3,927
Oklahoma	372	1	3	205	0	8	588
Oregon	484	28	0	70	6	10	599
Pennsylvania	2,440	63	46	814	15	33	3,412
Rhode Island	252	39	0	65	0	8	364
South Carolina	566	0	0	151	0	23	741
South Dakota	699	1	1	27	0	2	730
Tennessee	887	9	7	283	12	13	1,211
Texas	2,563	15	19	1,133	3	136	3,869
Utah	273	9	1	62	18	17	380
Vermont	63	0	0	12	0	0	76
Virginia	786	2	9	251	0	46	1,093
Washington	836	12	0	43	2	6	900
West Virginia	293	0	1	123	0	5	422
Wisconsin	658	10	1	152	1	20	842
Wyoming	37	0	0	28	0	1	66
Puerto Rico	25	0	0	11	0	0	37

Note: Preliminary year-to-date data. Zeros indicate amounts of less than $500,000.

Noninterest income of national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Service charges on deposit accounts	Gains (losses) on foreign exchange transactions	Gains (losses) on fees from assets in trading accounts	Other noninterest income + extraordinary items	Gains (losses) on assets not in trading accounts	Total noninterest income and gains (losses) on assets not in trading accounts
All national banks	$4,736	$691	$626	$16,122	$462	$22,636
Alabama	49	2	0	107	4	163
Alaska	9	0	0	19	0	29
Arizona	84	1	1	151	1	238
Arkansas	32	0	4	63	2	100
California	721	166	22	1,484	4	2,398
Colorado	81	1	0	176	2	260
Connecticut	55	0	1	161	2	219
Delaware	3	0	0	1,537	0	1,540
District of Columbia	23	0	0	60	2	86
Florida	291	4	1	410	15	722
Georgia	183	1	6	300	0	489
Hawaii	1	0	0	1	0	1
Idaho	15	0	-4	13	0	24
Illinois	197	15	-10	419	7	628
Indiana	80	0	1	190	-1	271
Iowa	29	0	0	133	30	193
Kansas	38	0	0	56	4	99
Kentucky	43	0	1	75	1	120
Louisiana	76	0	2	108	-1	184
Maine	4	0	0	9	0	13
Maryland	112	2	1	123	12	250
Massachusetts	96	24	7	456	-3	580
Michigan	102	6	2	243	4	359
Minnesota	93	6	-13	449	-20	515
Mississippi	29	0	1	39	7	75
Missouri	87	4	17	167	4	279
Montana	7	0	0	14	1	22
Nebraska	31	0	0	115	1	148
Nevada	16	0	0	696	0	712
New Hampshire	1	0	0	98	0	99
New Jersey	191	1	3	289	14	498
New Mexico	22	0	-1	36	0	57
New York	249	403	415	2,829	276	4,174
North Carolina	143	9	90	405	0	648
North Dakota	6	0	0	14	1	21
Ohio	206	7	-1	891	12	1,116
Oklahoma	57	1	3	83	0	145
Oregon	80	1	1	178	0	260
Pennsylvania	217	17	6	704	33	978
Rhode Island	13	0	0	129	1	142
South Carolina	62	0	1	62	1	126
South Dakota	9	-1	0	951	1	960
Tennessee	109	0	56	262	22	448
Texas	470	11	6	772	12	1,271
Utah	34	0	-4	78	0	107
Vermont	4	0	0	8	-1	12
Virginia	85	0	0	148	12	245
Washington	112	5	9	204	0	330
West Virginia	17	0	0	37	1	56
Wisconsin	54	1	0	158	1	213
Wyoming	4	0	0	6	-1	10
Puerto Rico	1	0	0	1	0	3

Note Preliminary year-to-date data. Zeros indicate amounts of less than $500,000.

Interest expense of national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Interest on deposits	*Expense of federal funds transactions*	*Interest on Treasury demand notes and other borrowed money*	*Interest on mortgage and capitalized leases*	*Interest on subordinated notes and debentures*	*Total interest expense*
All national banks	$21,893	$3,106	$6,422	$48	$721	$32,189
Alabama	220.6	42	13	0	1	276
Alaska	28.8	7	0	0	0	36
Arizona	200.68	18	63	0	7	288
Arkansas	144.29	4	3	1	1	152
California	1668.15	101	278	7	120	2,174
Colorado	215.19	23	1	1	1	241
Connecticut	172.92	94	19	0	1	287
Delaware	166.59	31	207	2	17	424
District of Columbia	72.99	9	1	0	0	83
Florida	843.29	159	22	1	6	1,031
Georgia	472.79	167	23	1	17	681
Hawaii	2.58	0	0	0	0	3
Idaho	48.99	11	2	0	1	64
Illinois	1006.94	138	56	11	51	1,263
Indiana	425.12	76	24	0	0	525
Iowa	149.41	29	18	0	1	199
Kansas	168.31	16	8	0	0	192
Kentucky	217.1	44	8	0	2	271
Louisiana	222.46	24	5	0	0	251
Maine	26.85	2	1	0	0	30
Maryland	261.02	73	26	1	3	364
Massachusetts	537.36	111	317	1	20	986
Michigan	500.14	70	68	1	17	655
Minnesota	319.43	84	47	1	4	456
Mississippi	119.44	20	2	0	0	142
Missouri	312.02	80	20	2	2	417
Montana	27.51	2	0	0	0	30
Nebraska	180.52	10	2	1	3	197
Nevada	45.55	6	65	0	0	116
New Hampshire	34.88	12	10	0	0	57
New Jersey	688.78	62	7	1	17	775
New Mexico	78.64	8	1	0	0	88
New York	6390.05	297	4,246	5	278	11,215
North Carolina	566.54	272	234	2	13	1,087
North Dakota	42.67	1	1	0	1	45
Ohio	983.21	216	127	2	39	1,367
Oklahoma	209.17	18	7	0	1	235
Oregon	127.6	22	21	0	3	174
Pennsylvania	883.81	180	235	1	31	1,330
Rhode Island	112.16	21	21	0	2	156
South Carolina	201.43	79	9	0	4	293
South Dakota	112.75	32	73	0	4	221
Tennessee	392.07	55	25	0	4	476
Texas	1175.72	199	55	2	27	1,459
Utah	94.62	38	12	0	2	146
Vermont	25.61	2	1	0	0	30
Virginia	379.01	49	15	1	6	450
Washington	202.54	24	11	1	8	246
West Virginia	135.07	13	3	0	0	151
Wisconsin	245.75	56	11	0	5	318
Wyoming	21.57	2	0	0	0	23
Puerto Rico	12.12	0	0	0	1	13

Note: Preliminary year-to-date data. Zeros indicate amounts of less than $500,000.

Noninterest and other expense of national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Provision for loan and lease losses	*Provision for allocated transfer risk*	*Salaries and employee benefits*	*Expenses of premises and fixed assets*	*Applicable income taxes*	*Other noninterest expense*	*Total noninterest and other expense*
All national banks	$2,891	–$10	$16,967	$5,435	$6,835	$18,600	$50,719
Alabama	15	0	178	53	59	134	439
Alaska	2	0	42	12	14	21	91
Arizona	64	0	218	54	95	278	708
Arkansas	4	0	96	28	43	91	262
California	360	0	2,016	747	964	1,644	5,731
Colorado	6	0	214	61	77	278	636
Connecticut	1	0	208	66	60	270	605
Delaware	281	0	347	85	331	975	2,018
District of Columbia	–2	0	67	25	15	82	187
Florida	55	–6	587	236	378	821	2,072
Georgia	95	0	340	111	140	542	1,228
Hawaii	0	0	4	2	0	2	9
Idaho	4	0	30	8	17	48	108
Illinois	63	0	699	238	211	536	1,747
Indiana	38	0	284	88	143	306	858
Iowa	25	0	110	33	70	138	376
Kansas	5	0	109	29	45	115	303
Kentucky	15	0	139	41	54	147	397
Louisiana	–24	0	211	58	68	184	497
Maine	–18	0	18	5	2	16	24
Maryland	9	0	269	88	107	232	706
Massachusetts	77	0	485	148	182	496	1,387
Michigan	52	0	412	115	134	315	1,028
Minnesota	5	0	325	102	151	494	1,077
Mississippi	4	0	90	25	34	72	224
Missouri	17	0	250	64	109	233	675
Montana	8	0	23	7	11	33	82
Nebraska	26	0	122	40	58	138	384
Nevada	103	0	75	18	193	380	771
New Hampshire	13	0	7	2	42	122	186
New Jersey	200	0	557	198	133	689	1,777
New Mexico	2	0	66	20	25	57	170
New York	799	0	3,007	963	656	2,615	8,040
North Carolina	30	0	500	146	172	491	1,339
North Dakota	3	0	26	8	12	24	73
Ohio	170	0	770	214	427	1,197	2,778
Oklahoma	4	0	155	42	42	148	391
Oregon	18	0	216	63	67	200	563
Pennsylvania	75	0	894	299	345	738	2,351
Rhode Island	7	0	95	22	57	82	263
South Carolina	–25	0	134	47	77	196	429
South Dakota	178	0	104	24	173	701	1,181
Tennessee	24	0	357	89	120	348	938
Texas	30	–3	1,172	404	354	985	2,943
Utah	–3	0	88	20	42	120	267
Vermont	3	0	18	6	3	19	49
Virginia	42	0	266	109	65	253	736
Washington	13	0	258	87	123	279	760
West Virginia	8	0	85	22	44	76	236
Wisconsin	13	0	202	60	81	211	566
Wyoming	0	0	15	4	5	16	40
Puerto Rico	1	0	7	3	1	7	20

Note. Preliminary year-to-date data. Zeros indicate amounts of less than $500,000.

*Value of securities not in trading account at domestic offices of national banks, by state, June 30, 1994**

(Dollar amounts in millions)

	U.S. Treasury securities	U.S. government issued or guaranteed certificates of participation	Other U.S. government agency and corporation obligations	Securities issued by states and political subdivisions in the U.S.	Other domestic debt securities	Foreign debt securities	Equity securities
All national banks	$139,757	$100,237	$105,136	$34,526	$27,836	$1,030	$7,525
Alabama	647	1,677	2,014	773	193	12	53
Alaska	792	41	246	195	127	0	14
Arizona	2,144	1,419	2,046	118	889	1	46
Arkansas	1,610	467	1,913	717	145	1	43
California	4,552	7,590	6,100	724	2,989	24	524
Colorado	2,303	2,907	1,260	461	490	0	71
Connecticut	3,668	4,229	212	17	1,226	6	65
Delaware	742	133	294	20	152	1	44
District of Columbia	787	757	570	37	517	2	30
Florida	8,140	3,017	5,347	1,377	1,422	40	407
Georgia	5,161	1,926	1,448	1,151	352	79	174
Hawaii	32	0	13	1	0	0	2
Idaho	186	73	198	34	54	0	24
Illinois	6,531	3,295	6,652	3,323	1,375	18	332
Indiana	1,701	3,545	2,276	1,260	551	2	131
Iowa	1,031	1,600	909	612	117	0	88
Kansas	1,526	1,153	2,150	703	116	2	71
Kentucky	2,155	423	1,068	872	226	0	85
Louisiana	4,100	3,032	2,349	338	162	3	103
Maine	160	60	88	18	27	0	13
Maryland	3,742	1,157	3,191	640	226	4	154
Massachusetts	3,435	3,123	1,672	63	1,101	95	272
Michigan	2,211	7,362	3,197	1,235	606	61	119
Minnesota	1,624	3,321	1,002	841	403	5	195
Mississippi	1,154	300	1,894	603	144	1	31
Missouri	4,424	1,663	2,775	832	798	3	46
Montana	121	336	112	30	12	0	10
Nebraska	1,288	460	1,018	646	55	0	57
Nevada	596	406	572	15	261	0	22
New Hampshire	96	69	46	10	16	1	10
New Jersey	6,632	5,116	4,071	1,490	2,219	59	201
New Mexico	675	736	1,130	227	74	0	27
New York	7,606	3,604	2,905	2,901	783	371	1,693
North Carolina	10,732	1,167	482	1,129	411	4	80
North Dakota	164	402	235	66	10	0	16
Ohio	6,868	4,761	5,514	2,111	1,798	19	300
Oklahoma	2,553	1,350	2,599	744	195	1	124
Oregon	896	498	495	305	65	0	19
Pennsylvania	6,244	7,092	13,521	1,614	2,524	88	501
Rhode Island	1,008	1,012	0	17	46	4	48
South Carolina	2,579	1,027	1,299	280	35	3	48
South Dakota	171	638	81	125	10	0	32
Tennessee	2,794	1,729	4,488	983	249	3	154
Texas	16,235	10,491	10,046	2,005	2,709	45	357
Utah	543	259	1,001	211	166	0	226
Vermont	104	134	134	27	3	0	18
Virginia	3,368	2,283	1,351	525	1,049	64	125
Washington	418	300	258	233	88	0	121
West Virginia	982	403	1,762	565	181	0	63
Wisconsin	2,057	1,040	827	1,198	371	8	125
Wyoming	362	561	194	73	74	0	10
Puerto Rico	105	92	115	30	27	0	3

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.

Note: Preliminary end-of-quarter data. Zeros indicate amounts of less than $500,00

Selected off-balance sheet items at national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Unused commitments	Letters of credit	Securities lent	Mortgages transferred to FNMA and FHLMC with recourse	Notional value of swap contracts	When-issued securities and futures and forward contracts	Written and purchased option contracts
All national banks	$1,027,298	$97,333	$22,568	$5,662	$1,635,162	$4,481,680	$1,242,344
Alabama	6,457	775	22	3	2,648	197	1,104
Alaska	584	13	0	0	249	53	0
Arizona	34,547	245	124	6	5,711	152	353
Arkansas	1,514	80	0	11	0	53	106
California	86,969	14,387	5,851	71	326,869	817,065	98,628
Colorado	8,412	316	260	0	3,632	30	18
Connecticut	7,472	999	0	137	3,895	8,254	1,861
Delaware	168,656	1	0	0	9,302	119	1,706
District of Columbia	884	95	0	0	538	34	400
Florida	25,832	1,920	50	239	8,641	3,814	5,089
Georgia	36,646	2,860	28	47	9,402	1,831	1,308
Hawaii	66	2	0	0	0	0	0
Idaho	1,332	35	0	0	1,346	2,754	1,705
Illinois	44,302	4,772	161	3	172,943	350,569	118,404
Indiana	13,477	1,161	539	17	6,700	533	1,029
Iowa	8,267	217	250	0	348	4	0
Kansas	3,072	126	6	12	151	13	0
Kentucky	3,375	407	39	22	1,485	1	175
Louisiana	4,541	276	125	26	603	16	206
Maine	386	15	0	0	210	0	82
Maryland	6,980	1,083	171	16	6,304	1,090	1,022
Massachusetts	25,337	2,910	8	49	19,025	53,843	35,486
Michigan	22,512	1,614	0	90	6,572	4,136	560
Minnesota	14,929	1,603	343	60	7,151	5,100	2,892
Mississippi	1,636	109	374	0	455	505	700
Missouri	9,804	1,009	340	0	3,785	2,280	112
Montana	1,060	38	10	0	140	0	0
Nebraska	9,680	132	0	0	285	2	0
Nevada	17,065	60	0	0	7,720	2,348	11,423
New Hampshire	5,610	2	0	0	491	0	389
New Jersey	12,376	1,195	519	22	13,254	3,735	2,499
New Mexico	749	38	0	4	351	2,074	390
New York	109,117	34,656	3,458	3,506	771,022	3,062,526	679,027
North Carolina	30,832	4,138	0	29	66,356	100,928	233,198
North Dakota	677	21	16	0	35	0	0
Ohio	68,865	3,510	112	68	60,243	3,383	12,570
Oklahoma	2,956	298	0	22	233	30	0
Oregon	12,700	462	0	10	2,572	2,006	517
Pennsylvania	36,029	7,226	1,857	316	41,379	17,028	8,429
Rhode Island	3,806	294	0	0	10,433	581	178
South Carolina	3,893	233	20	82	985	93	116
South Dakota	93,863	47	3	0	7,583	713	11,228
Tennessee	9,594	1,105	204	656	3,988	2,404	40
Texas	33,703	3,637	7,139	60	19,241	6,152	5,433
Utah	3,097	208	0	1	1,264	3,759	1,989
Vermont	436	27	0	0	20	4	12
Virginia	8,468	1,166	86	21	5,781	75	23
Washington	14,626	1,139	18	0	13,013	21,259	359
West Virginia	1,334	83	202	0	1,543	0	1
Wisconsin	8,489	572	229	52	9,268	133	1,558
Wyoming	165	13	5	0	0	0	0
Puerto Rico	120	2	0	0	0	0	20

Swap, futures and forward, and option contracts include interest rate, foreign exchange, and contracts.
Note Preliminary end-of-quarter data. Zeros indicate amounts of less than $500,000.

Outstanding balances, credit cards and related plans, by state, June 30, 1994
(Dollar amounts in thousands)

	Total number of national banks	*Credit cards and other related credit plans*	
		Number of national banks	Outstanding volume
All national banks	3,191	2,079	$93,923,511
Alabama	50	32	519,949
Alaska	4	3	61,160
Arizona	13	11	3,188,963
Arkansas	76	31	209,934
California	134	122	9,266,759
Colorado	132	114	1,361,729
Connecticut	11	10	46,872
Delaware	16	16	20,878,874
District of Columbia	15	12	58,333
Florida	120	69	3,480,598
Georgia	73	55	4,262,435
Hawaii	2	2	3,318
Idaho	6	6	134,748
Illinois	278	174	1,611,673
Indiana	61	56	1,366,060
Iowa	81	59	1,715,960
Kansas	137	45	495,475
Kentucky	76	47	229,255
Louisiana	40	21	530,275
Maine	7	6	31,981
Maryland	23	20	1,181,536
Massachusetts	23	18	218,294
Michigan	49	36	1,255,253
Minnesota	138	110	1,297,640
Mississippi	27	14	105,367
Missouri	62	43	700,658
Montana	30	21	212,290
Nebraska	103	53	1,636,607
Nevada	7	5	5,909,293
New Hampshire	7	5	1,089,941
New Jersey	40	35	520,329
New Mexico	32	21	70,321
New York	72	52	6,019,105
North Carolina	14	14	401,447
North Dakota	26	22	90,778
Ohio	123	100	7,309,485
Oklahoma	126	63	160,453
Oregon	7	7	1,439,317
Pennsylvania	129	86	1,124,197
Rhode Island	2	2	64,900
South Carolina	26	26	199,622
South Dakota	20	13	7,409,409
Tennessee	41	24	785,916
Texas	491	204	1,000,409
Utah	8	7	211,959
Vermont	9	7	66,205
Virginia	33	22	1,013,636
Washington	20	18	2,023,776
West Virginia	58	33	104,806
Wisconsin	91	87	875,745
Wyoming	21	19	16,690
Puerto Rico	1	1	14,804

Note: Preliminary end-of-quarter data.

Consolidated foreign and domestic loans and leases past due at national banks, by state, June 30, 1994
(Dollar amounts in millions)

	Number of banks	*Type of loan*						
		All real estate	Commercial and industrial*	Personal†	Leases	Other loans‡	Total loans	To non-U.S. addresses
All national banks	3,191	$8,486	$3,225	$5,915	$203	$688	$18,517	$619
Alabama	50	60	25	53	1	6	145	0
Alaska	4	20	6	6	0	5	37	0
Arizona	13	65	25	174	2	2	268	1
Arkansas	76	44	23	24	0	1	91	0
California	134	1,560	255	419	5	96	2,335	26
Colorado	132	51	51	46	1	1	149	0
Connecticut	11	177	32	34	0	12	255	0
Delaware	16	14	9	564	1	0	588	0
District of Columbia	15	23	6	3	0	16	48	5
Florida	120	459	67	163	0	6	695	2
Georgia	73	132	97	93	2	14	339	5
Hawaii	2	1	3	0	0	0	4	0
Idaho	6	12	6	15	0	5	39	0
Illinois	278	316	216	158	1	24	715	0
Indiana	61	197	115	205	5	14	537	0
Iowa	81	29	33	68	0	3	132	0
Kansas	137	30	44	26	1	5	105	0
Kentucky	76	69	41	55	3	12	180	0
Louisiana	40	47	21	58	0	2	128	0
Maine	7	16	6	3	0	0	25	0
Maryland	23	70	39	33	0	6	149	0
Massachusetts	23	278	110	52	13	3	456	9
Michigan	49	258	118	102	3	13	494	0
Minnesota	138	99	137	56	2	4	296	0
Mississippi	27	29	13	20	0	2	65	0
Missouri	62	75	97	53	0	5	230	0
Montana	30	9	18	10	0	1	37	0
Nebraska	103	18	31	74	1	5	128	0
Nevada	7	10	1	288	0	0	299	0
New Hampshire	7	10	1	34	0	0	45	0
New Jersey	40	836	347	129	22	50	1,384	3
New Mexico	32	28	9	15	0	1	53	0
New York	72	1,288	254	1,083	64	211	2,901	520
North Carolina	14	136	67	31	1	3	237	0
North Dakota	26	9	8	8	0	1	26	0
Ohio	123	340	181	518	9	17	1,065	0
Oklahoma	126	70	50	27	0	2	149	0
Oregon	7	34	16	35	8	0	93	0
Pennsylvania	129	510	111	252	43	80	995	39
Rhode Island	2	63	28	16	8	0	114	0
South Carolina	26	76	23	29	0	2	130	0
South Dakota	20	11	39	324	0	10	384	0
Tennessee	41	101	36	78	1	2	218	0
Texas	491	393	193	206	1	18	813	6
Utah	8	25	21	18	0	3	67	0
Vermont	9	15	8	3	0	0	26	0
Virginia	33	115	32	69	0	3	219	0
Washington	20	68	37	73	2	6	187	2
West Virginia	58	59	26	39	0	0	124	0
Wisconsin	91	117	84	64	3	14	282	1
Wyoming	21	3	6	3	0	1	14	0
Puerto Rico	1	16	1	3	0	0	20	0

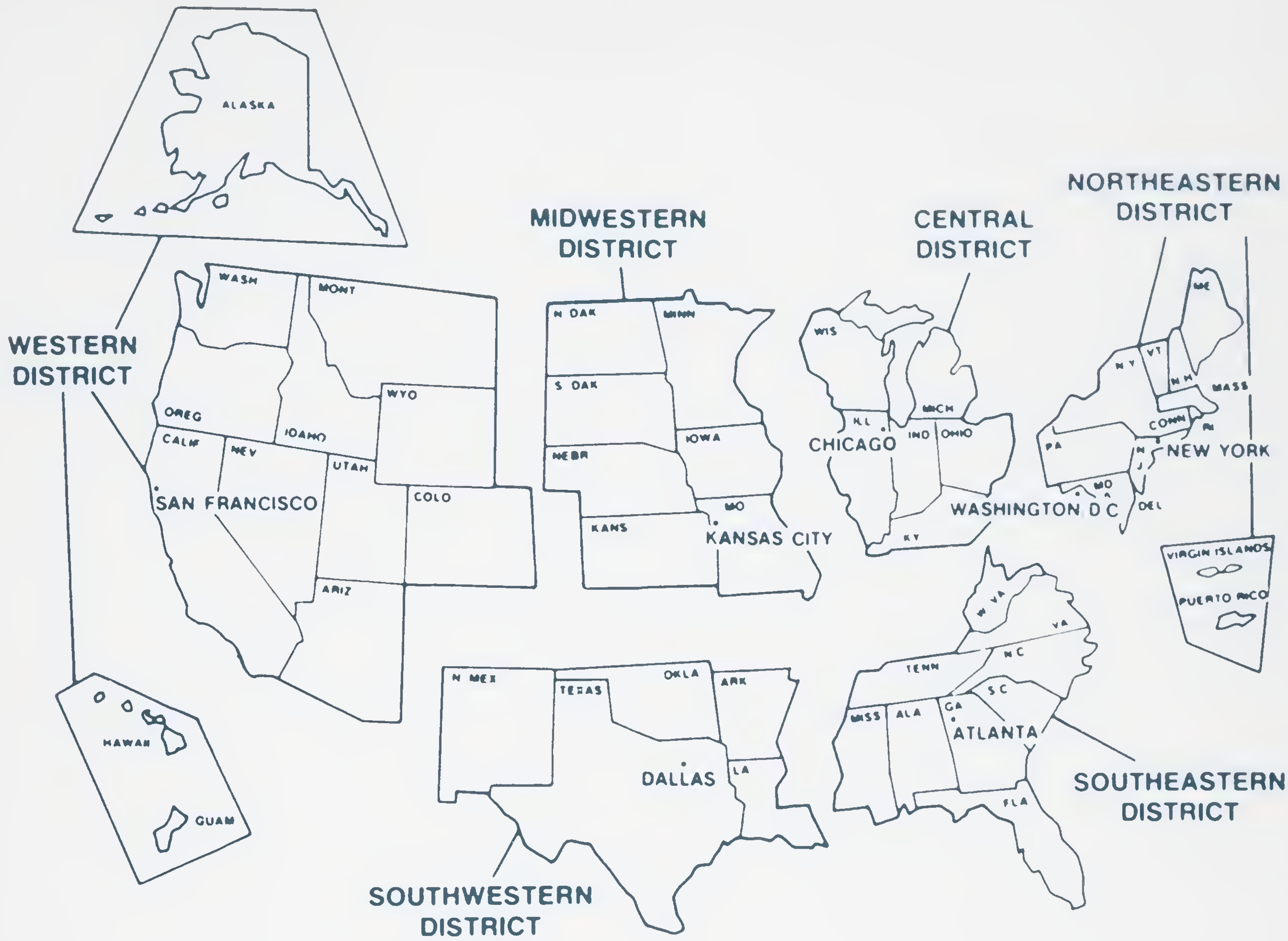
*For banks with assets of less than $300 million, this category captures commercial (time and demand) and all other loans.
†For banks with assets of less than $300 million, this category captures installment loans and credit cards and related plans.
‡Does not include banks with assets of less than $300 million

*Percent of loans past due, by asset size of national banks, June 30, 1994**

	Less than $300M	*$300M to $1B*	*$1B to $10B*	*Greater than $10B*	*All national banks*
Real estate					
September 1993	1.68	1.49	2.05	2.21	2.00
December 1993	1.57	1.37	1.84	2.23	1.93
March 1994	1.81	1.50	1.79	2.11	1.90
June 1994	1.45	1.21	1.54	1.76	1.58
Commercial and industrial†					
September 1993	3.26	2.24	1.37	0.78	1.11
December 1993	3.02	1.84	1.29	0.64	0.95
March 1994	3.71	2.27	1.32	0.67	1.02
June 1994	3.06	1.96	1.30	0.56	0.91
Personal‡					
September 1993	2.31	2.22	3.36	2.67	2.86
December 1993	2.38	1.99	3.11	2.54	2.70
March 1994	2.28	1.89	2.77	2.44	2.49
June 1994	2.13	1.98	2.32	2.28	2.25
Leases					
September 1993	1.45	0.86	1.06	0.54	0.71
December 1993	1.09	0.77	0.95	0.49	0.64
March 1994	0.79	0.80	0.73	0.46	0.54
June 1994	0.59	0.60	0.60	0.81	0.75
Other loans					
September 1993	NM	0.52	0.77	0.54	0.56
December 1993	NM	0.38	0.60	0.32	0.36
March 1994	NM	0.43	1.06	0.41	0.50
June 1994	NM	0.33	0.89	0.56	0.58
Total loans					
September 1993	1.87	1.73	2.15	1.55	1.76
December 1993	1.78	1.54	1.99	1.46	1.64
March 1994	2.02	1.66	1.91	1.42	1.61
June 1994	1.67	1.47	1.66	1.26	1.42

*Past due loans in each category are stated as a percentage of loans outstanding of that type.
†For banks with assets of less than $300 million, this category captures commercial (time and demand) and all other loans.
‡For banks with assets of less than $300 million, this category captures installment loans and credit cards and related plans.
Note: Preliminary end-of-quarter data.
NM = Not meaningful.

Index



Northeastern District

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1114 Avenue of the Americas
Suite 3900
New York, NY 10036-7780

(212) 819-9860

Central District

Chicago District Office
One Financial Place
Suite 2700
440 South LaSalle Street
Chicago, IL 60605-1073

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Southwestern District

Dallas District Office
1600 Lincoln Plaza
500 North Akard
Dallas, TX 75201-3394

(214) 720-0656

Southeastern District

Atlanta District Office
Marquis One Tower
Suite 600
245 Peachtree Center Ave., N.E.
Atlanta, GA 30303-1223

(404) 659-8855

Midwestern District

Kansas City District Office
2345 Grand Avenue
Suite 700
Kansas City, MO 64108-2683

(816) 556-1800

Western District

San Francisco District Office
50 Fremont Street
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